Volume 49 | Issue 3 Article 3

2004

Making It Easier to Milk the Cow: The Southern District of New York Collapses the Culpable Participation Doctrine and Sidesteps the Private Securities Litigation Reform Act

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Notes

MAKING IT EASIER TO MILK THE COW: THE SOUTHERN DISTRICT OF NEW YORK COLLAPSES THE CULPABLE PARTICIPATION DOCTRINE AND SIDESTEPS THE PRIVATE SECURITIES LITIGATION REFORM ACT

I. INTRODUCTION

The initial public offering ("IPO") frenzy occurring between 1998 and 2000, and the subsequent IPO collapse, continues to spawn litigation at a feverish pace.[1] Considered one of the most extreme examples of a hot issue market—one in which the prices of IPO stocks rise quickly in the market—the recent IPO boom is now the subject of intense scrutiny and massive class action litigation.[2] Although warning sirens began to wail early in the IPO explosion, the continued success of the stock market overshadowed much of the concern over the impetus for such historic price increases.[3] This changed, however, as stock prices plummeted and reports

1. *See* Randall Smith, *New Inquiries Are Targeting IPO "Spinning"*, WALL ST. J., June 30, 2003, at C1 (noting courts are deluged with cases resulting from IPO crash); Shawn Tully, *Will Wall Street Go Up in Smoke?*, FORTUNE, Sept. 3, 2001, at 36 (describing plaintiffs' attorneys rush to IPO class actions). Tully compares the potential lucrative settlements resulting from recent IPO class action suits to those handed to plaintiffs' attorneys bringing claims against tobacco companies. *See id.* (warning that litigation surrounding IPO boom may become "class action bonanza"). One attorney for a leading plaintiffs' attorney law firm is quoted as saying, "The courts are now deluged with cases, and the regulators have just scratched the surface." *See* Smith, *supra*, at C1 (anticipating proliferation of lengthy and burdensome litigation resulting from market bubble scandals); *see also* Tamara Loomis, *Judge to Weigh Dismissal of IPO Litigation*, N.Y.L.J., Oct. 24, 2002, at 1 (describing litigation related to IPO allegations as "flourishing all over the country"); Joanna Glasner, *Hot New IPO Trend: Suing*, WIRED (June 6, 2001), *at* http://www.wired.com/news/ipo/0,1350,44250,00.html (describing sweeping investigations and increasing number of lawsuits in response to IPO boom and bust).

2. *See In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 300-08 (S.D.N.Y. 2003) (demonstrating enormity of class action suits); *see, e.g., id.* at 306 (describing IPO market of 1998 to 2000 as more extraordinary than previous three hot issue markets). *See generally* Jay R. Ritter, *The "Hot Issue" Market of 1980*, 57 J. BUS. 215 (1984) (describing elements of hot issue market); *see also* Jay R. Ritter, *Big IPO Runups of 1975—September 2000* (Aug. 2001), *at* http://bear.cba.ufl.edu/ritter/runup750.pdf [hereinafter *Big IPO*] (providing statistical data on IPO boom and first day trading price increases); *cf. Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. DOC. NO. 88-95, pt. 1, at 159-62 (1963) (summarizing findings regarding hot issue market of 1959–1962).

3. *See* Dominic Basulto, *The IPO Controversy*, pt. III, *at* http://www.corante.com/reports/ipo/ (last visited Jan. 16, 2004) (referencing *Internet IPOs: An Insider's Game*, MCKINSEY Q., 2000 No. 1). The *McKinsey* report recognized the dangerous trends involved in the IPO boom. *See id.* (describing analysis undertaken in

began to surface that the record-shattering IPO market may have been rigged.[4] In response to these widespread allegations and recent government probes, investors and plaintiffs' attorneys have flooded the courts.[5]

McKinsey Quarterly, which discusses IPO boom). "'But crackling behind the song, you can hear the distortions of a market that has primarily rewarded insiders and short-term investors . . . .'" *Id.* "In a bull market, these investment banking practices generated little or no regulatory attention. As long as the shares of hot IPO companies continued to trade at a higher price, all parties concerned . . . could profit from the ongoing technology boom." *Id.* at Introduction; *see also* Brian Trumbore, *The Bubble, Part II, at* http://www.buyandhold.com/bh/en/education/history/2002/bubble_2.html (last visited Jan. 16, 2004) (providing weekly review of financial markets and major events between January 8, 2000, and June 3, 2000). The author revisits previous postings on his website to expose the clear warning signs regarding overvalued stocks in 2000. *See id.* (presenting comments from author's previous columns). Of particular note is a quote from Warren Buffet, who was notably conservative during the hot issue market, taken during an annual meeting of Berkshire Hathaway: "In the past year [1999-2000], the ability to monetize shareholder ignorance has never been greater." *See id.* (explaining his perception that media hype and bullish outlooks allowed issuing companies to capitalize on investors' willingness to enter securities markets without understanding reasons for rise in prices).

4. *See Was IPO Frenzy Rigged?* (Nov. 13, 2002), *at* http://www.cbsnews.com/stories/2002/11/13/60II/printable529225.shtml (noting that some insiders claim price leaps in IPOs were result of insider agreements). An often-used technique called "laddering" is held primarily, but not solely, responsible for the IPO boom by many accounts. *See id.* (explaining use and frequency of laddering agreements during recent hot issue market). Laddering is defined as follows:

> Laddering—Technique for driving up the price of shares after the IPO. Essentially, underwriters offer shares at the offering price (which is almost always lower than the initial trading price) in exchange for guarantees from buyers to purchase additional shares at progressively higher prices after the opening. Each higher price, then, forms the next "rung" on the ladder.

Basulto, *supra* note 3, pt. IV (providing glossary of terms related to IPO practices and schemes). The mechanics of the technique are widely known and often described as commonplace. *See* Nicholas W. Maier, *Original Sin* (May 13, 2002), *at* http://www.dotcomscoop.com/sin.html (providing account from employee at Cramer & Company detailing laddering scheme). The author highlights the precise behavior, artificially driving the price of IPO stocks up, being targeted in recent litigation. *See id.* (same). *See generally* Gregg Wirth, *The Bubble That Wasn't* (Feb. 4, 2002), *at* http://www.tompaine.com/feature2.dfm/ID/5074/ (describing driving forces underlying IPO boom). "It was really a bubble created by Wall Street for the enrichment of Wall Street . . . ." *Id.*

5. *See* Suzanne Miller, *Banks Under Legal Siege*, BANKER (Mar. 2003), *at* http://www.thebanker.com/news/fullstory.php/aid/250/Banks_under_legal_siege.html (describing current legal siege of banks). "An army of lawyers representing scores of banks and thousands of plaintiffs are squaring off for a battle where tens of billions of dollars in claims are at stake." *Id.* The author describes at length, with the assistance of bankers and plaintiffs' attorneys, the atmosphere in the United States following the IPO collapse and the pending legal battles. *See id.* (discussing nationwide effect of IPO collapse). Summarizing the feeling on Wall Street, one lawyer stated, "It seems there's no end in sight." *See id.* (explaining numerous legal challenges facing Wall Street and dangers associated with going to trial); *see also* Loomis, *supra* note 1, at 1 (noting importance of government probes in increasing litigation). Initial complaints alleging abuses in the context of IPOs did not receive support. *See id.* (describing response to initial complaints filed in courts in

The legal strategies employed in an effort to recover damages from those participating in the IPO schemes vary; however, one of the most important and controversial strategies is the use of Section 20(a) of the Securities Exchange Act of 1934[6] ("Exchange Act").[7] In one of the largest private securities class actions in the history of the United States, the Southern District of New York addressed the debate concerning the controlling person liability pleading requirements of Section 20(a).[8]

In *In re Initial Public Offering Securities Litigation* ("*IPO Litigation*"),[9] the Southern District of New York sent a shockwave through Wall Street as it contradicted two of its own decisions regarding controlling person liability.[10] Attempting to extinguish the controversy surrounding the pleading

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various jurisdictions). "[A] steady stream of headline-making government probes have given lawsuits a huge boost in the arm." *Id.*; *cf.* Thomson v. Morgan Stanley Dean Witter & Co., No. CIV. 01-7071-MP, 2001 WL 958925, at *2 (S.D.N.Y. Aug. 21, 2001) (dismissing related securities class action, targeting research analysts, including well-known analyst Mary Meeker). Judge Milton Pollack presented his view of the plaintiffs' complaint:

> The pleading improprieties in the complaint are gross and unrestrained . . . . The repetitive character of the improprieties is unmitigated. A collection of market gossip pervades the endless stream of news organization tidbits which are spread throughout. Generally, these are expectable comments of the gamblers in the world's gaming pits depending on the season. They come during the inevitable sequel after the market boom periods.

Id.

6. Pub. L. No. 73-291, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78kk (2000)).

7. *See, e.g., In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 308-14 (highlighting various legal strategies available to damaged investors); *see also id.* at 392-93 (noting deep division among circuits over whether Section 20(a) has scienter element). *See generally* Sandra P. Wysocki, Note, *Controlling Personal Liability of Directors Under Section 20(a) of the Securities Exchange Act of 1934*, 31 SUFFOLK U. L. REV. 695, 705-06 (1998) (discussing Congress's goals in enacting Securities Acts and investors' remedies under Securities Acts).

8. *See* Dan Ackman, *IPO Settlement Does Not Settle Much* (June 26, 2003); *at* http://www.forbes.com/2003/06/26/cx_da_0626ipo.html (outlining proposed settlement between plaintiffs' attorneys representing shareholders and insurers for Issuers); *see also Investors Settle with Internet Companies in IPO Suits* (June 26, 2003), *at* http://quote.bloomberg.com/apps/news?pid=10000103&sid=aMBLzCTbeId0&refer=US# (providing summary and analysis of settlement as well as potential implications for defendant banks). "A proposed settlement announced today . . . offers plaintiffs a guaranteed minimum recovery of $1 billion . . . ." Ackman, *supra.* According to Melvyn Weiss, head of the committee of shareholder lawyers, an agreement to the proposed settlement would result in one of the largest settlements in history. *See id.* (detailing terms of proposed memorandum of understanding and distinguishing impact on issuer companies from underwriters); *see also* Steve Maich, *Wall Street Readies to Pay Up—Again: IPO Class Actions: Brokerages May Pay US $3-Billion to Settle Suits Quickly*, NAT'L POST, Feb. 21, 2003, *available at* 2003 WL 11546410 (describing enormity of decision in securities class action).

9. 241 F. Supp. 2d 281 (S.D.N.Y. 2003).

10. *See id.* at 396-97 (summarizing holding of case and noting abrogation of prior decisions). The court overruled its holdings in *In re Independent Energy Holdings PLC Securities Litigation* and *Gabriel Capital, L.P. v. NatWest Finance, Inc. See id.*

requirements for controlling person liability and the application of the Private Securities Litigation Reform Act ("PSLRA"),[11] the court denied a motion to dismiss claims alleged under Section 20(a) of the Exchange Act.[12] Specifically, the court in *IPO Litigation* held that proof of scienter is not required to adequately *plead* controlling person liability and that the PSLRA does not apply to Section 20(a) claims.[13] In doing so, the court squarely addressed two controversial legal issues: (1) whether Section 20(a) requires pleading a culpable state of mind and (2) whether the heightened pleading requirements set forth under the PSLRA apply to Section 20(a) allegations.[14] The Southern District of New York's decision fueled the national debate regarding the pleading requirements under Section 20(a) and the PSLRA.[15] Moreover, this holding potentially

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(holding that neither Private Securities Litigation Reform Act (PSLRA) nor Rule 9(b) apply to Section 20(a) claim); *see also id.* at 397 (describing decision to abrogate prior rulings).

11. 15 U.S.C. § 78u-4 (2000).

12. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 295-98 (summarizing holdings of case). "Because Plaintiffs have adequately alleged control, the Section 20 claims survive [the motion to dismiss] . . . . In sum, Plaintiffs have pled a coherent scheme by Underwriters, Issuers, and their officers to defraud the investing public. As such, these lawsuits may proceed." *Id.* at 298. *See generally id.* at 393-96 (discussing application of PSLRA, Section 20(a) and split among circuits regarding these issues).

13. *See id.* at 295-98 (summarizing holdings of case).

14. *See id.* at 392-93 (framing issues before court in hearing defendants' motions to dismiss); *see also* Martin Flumenbaum & Brad S. Karp, *Requirements for Pleading Securities Fraud*, N.Y.L.J., Jan. 25, 1995, at 3 (describing importance and controversy surrounding pleading requirements for plaintiffs asserting federal securities claims). "The issue at stake . . . is one of extreme importance that has been painstakingly developed and refined by district courts and circuit courts . . . ." *Id.* The Supreme Court has declined the opportunity to review the pleading standard established by the PSLRA. *See* HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 29.12, at 1721 (2002) (noting Supreme Court was presented with petition for certiorari during term commencing October 2000); *id.* at 1722-24 (detailing basis for and denial of petition for certiorari); *see also* Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000), *petition for cert. filed*, Sept. 19, 2000 (No. 00-432) (seeking Supreme Court review).

15. *See generally* James Lockhart, Annotation, *Liability of Brokerage Firm, Securities Underwriter, Investment Advisor, or Similar Entity, or Individual Affiliated with Such Entity, as "Control Person" Under § 15 of Securities Act (15 U.S.C. § 77o) and § 20(a) of Securities Exchange Act (15 U.S.C. § 78t(a))*, 186 A.L.R. FED. 169, § 4, at 205 (2003) (including holding in *In re Initial Pub. Offering Sec. Litig.* in section regarding less specificity in pleading requirements); Arthur R. Miller, Comment, *The Pretrial Rush to Judgment: Are the "Litigation Explosion," "Liability Crisis," and Efficiency Clichés Eroding Our Day in Court and Jury Trial Commitments?*, 78 N.Y.U. L. REV. 982, 1133-34 (2003) (describing problems with balancing judicial efficiency and litigants' ability to gain full access to hearing). One commentator quoted a judge's articulatation of the issue as follows:

> On the one hand, there is the interest in deterring fraud in the securities markets and remedying it when it occurs . . . . On the other hand, there is the interest in deterring the use of the litigation process as a device for extracting undeserved settlements . . . .

awarded plaintiffs' attorneys and private litigants a significant victory while eviscerating the protections established under the PSLRA.[16]

This Note considers the recent developments in the pleading requirements for claims brought under Section 20(a) of the Exchange Act as well as the increasing importance of this section.[17] In particular, it examines the Southern District of New York's decision in *IPO Litigation*.[18] This ruling provides an ideal backdrop for defining the interaction between the PSLRA and Section 20(a) of the Exchange Act due to its size, potential for extraordinary damage awards, jurisdiction and historical context.[19] This Note focuses primarily on the requirements for pleading a Section 20(a)

Elliott J. Weiss, *Pleading Securities Fraud*, 64 LAW & CONTEMP. PROBS. 5, 5 (2001) (quoting *In re* Time Warner, Inc., Sec. Litig., 9 F.3d 259, 263 (2d Cir. 1993) (Newman, C.J.)). "The importance of Second Circuit jurisprudence on this subject is reflected by the fact the Second Circuit is now the circuit where the largest number of securities class actions are filed." Richard Slack & Sirin Thada, *Control Person Liability Under the Exchange Act; Possible Shift in Standard in S.D.N.Y.*, BUS. SEC. LITIGATOR, at 6 n.2 (Nov. 2003), *available at* http://www.weil.com/wgm/cwgmhomep.nsf/Files/BSLNov03/$file/BSLNov03.pdf.

16. *See* Lyle Roberts, *The Perfect Storm* (June 19, 2003), *at* http://www.the10b-5daily.com/archives/000102.html (describing potential narrowing application of PSLRA); *see also* Timothy E. Hoeffner & Ashish D. Gandhi, *Enron Court Clarifies Pleading Standard for Individual Representatives of a Professional Accounting Firm*, 15 SEC. REFORM ACT LITIG. REP. 22, 24-26 (Apr. 2003), *available at* http://www.saul.com/articles/Litigation/art_2003_04.pdf (describing negative implications for defense counsel resulting from reducing application of PSLRA).

17. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393-97 (analyzing pleading requirements under Section 20(a)). The court abrogated two of its own cases with respect to the pleading requirements set forth under the PSLRA. *See id.* at 396-97 (overruling prior holdings); *see also* Hoeffner & Gandhi, *supra* note 16, at 22-23 (explaining recent developments in pleading requirements).

18. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (summarizing court's ruling on defendants' motion to dismiss for failure to adequately plead Section 20(a) claims).

19. *See* Steve Maich, *supra* note 8 (describing silence on Wall Street as "almost deafening" after federal court ruled class action lawsuit can proceed). One commentator estimated the magnitude of damages facing Wall Street at $3 billion, which would likely be spread across the more than fifty investment banks named in the class action. *See id.* (discussing commentator's guess as to amount of damages facing Wall Street due to class action lawsuit); *see also* Ackman, *supra* note 8 (describing terms of proposed settlement between class of plaintiffs and issuer of defendants' insurers). The settlement guarantees a minimum recovery of $1 billion from the insurers of the issuer defendants; however, the case will proceed against the fifty-five investment bank defendants. *See id.* (discussing minimum settlement recovery for cases against fifty-five underwriters). Melvyn Weiss, head of the committee of shareholder lawyers, noted that this would place this settlement among the largest securities class action settlements ever. *See id.* (providing Weiss's view about relative size of settlement); *see also In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 306-08 (providing historical context surrounding case before Southern District of New York). Judge Scheindlin noted that the economic successes and failures during this period—1998 to 2000—have been documented by numerous books, several documentaries and at least one play. *See id.* (discussing extensive media coverage of recent IPO market).

claim.[20] Part II provides the historical framework, legal background and legislative history required for an understanding of the inquiry involved in the *IPO Litigation* case.[21] Part III.A. outlines the specific facts and relevant history of the *IPO Litigation* case.[22] Part III.B. establishes the district court's reasoning in holding that Section 20(a) claims do not require proof of a requisite state of mind at the pleading stage and therefore need not satisfy the requirements of the PSLRA.[23] Part III.C. critically examines the court's analysis and its resulting conclusions.[24] Part IV addresses the potential impact of the holding in *IPO Litigation* on the future of controlling person liability and, more generally, the potential increase in secondary liability exposure under Section 20(a) of the Exchange Act in the event the PSLRA is circumvented.[25] Finally, Part V sets forth brief conclusions based on the analysis contained within this Note.[26]

II. BACKGROUND

A. *Overview of the Securities Acts*

From 1929 until 1933, the U.S. securities markets lost half their total value and twenty percent of the U.S. workforce was unemployed.[27] In response, Congress enacted the Securities Act of 1933 ("Securities Act")[28] and the Exchange Act (collectively, "Securities Acts") to protect the integ-

20. For a detailed discussion of the division over pleading requirements for a Section 20(a) claim, see *infra* notes 59-149.

21. For a further discussion of the pleading requirements established for claims alleging violations of Section 20(a) of the Exchange Act and, more generally, the federal securities laws and the PSLRA, see *infra* notes 27-149 and accompanying text.

22. For a further discussion of the facts of *In re Initial Public Offering Securities Litigation*, see *infra* notes 150-58 and accompanying text.

23. For a narrative discussion of the Southern District of New York's reasoning in *In re Initial Public Offering Securities Litigation*, see *infra* notes 159-76 and accompanying text.

24. For a critical discussion of the the Southern District of New York's reasoning in *In re Initial Public Offering Securities Litigation*, see *infra* notes 177-201 and accompanying text.

25. For a further discussion of the possible impact of *In re Initial Public Offering Securities Litigation* on secondary liability exposure under Section 20(a), see *infra* notes 202-11 and accompanying text.

26. For conclusions based on the foregoing analysis, see *infra* notes 212-15 and accompanying text.

27. *See* Laura Greco, Note, *The Buck Stops Where?: Defining Controlling Person Liability*, 73 S. CAL. L. REV. 169, 169-75 (1999) (providing background information on enactment of Securities Acts); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (describing Securities Acts and underlying legislative intent). "The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets . . . ." *Id.*

28. Pub. L. No. 73-22, ch. 38, tit. I, § 1, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)).

rity of the securities markets and to combat fraudulent practices.[29] Congress believed the abuses within the securities markets were largely responsible for the bull market crash of the 1920s and, more specifically, the 1929 stock market crash.[30] With this in mind, the Securities Acts sought to end the ineffective self-regulation of the securities markets.[31]

The Exchange Act created five explicit provisions designed to curb the practices Congress discovered during its investigations.[32] Among these provisions, Congress included Section 20(a) to address the potential liability of those individuals in controlling relationships with the primary violators of the Exchange Act.[33] Section 20(a) attempts to "extend liability to persons who might not be covered by common-law secondary liability" by imposing joint and several liability on persons who "control"

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29. *See In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 298-99 (S.D.N.Y. 2003) (outlining intent of Securities Acts); *see also* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 33-35 (3d ed. 1995) (providing background information on Securities Acts).

30. *See generally* J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973) (describing congressional investigations into practices underlying securities trading and detailing legislative history of Securities Acts). These investigations repeatedly uncovered market manipulation and deceptive practices that Congress believed contributed to the market collapse. *See id.* (discussing results and implications of congressional investigations); *see also* LOSS & SELIGMAN, *supra* note 29, at 34-35 (describing purpose of Securities Acts). The Securities Act primarily focuses on the initial distribution of securities rather than the subsequent trading transactions, while the Exchange Act focuses on trading occurring after the initial distribution, specifically disclosure requirements. *See id.* (discussing regulatory focus of Securities Acts).

31. *See* Greco, *supra* note 27, at 169 (describing structural flaws of Wall Street and pitfalls of self-regulation); *see also* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) ("[A] fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a higher standard of business ethics in the securities industry."); Wysocki, *supra* note 7, at 705-06 (describing Congress's intent in enacting Securities Exchange Act of 1934). Congress's broad disclosure requirements and antifraud provisions signaled a dramatic shift from the status quo of caveat emptor. *See id.* (noting philosophical shift resulting from Exchange Act).

32. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 299 n.13 (outlining five explicit provisions creating civil liability under Exchange Act).

> The Exchange Act's five explicit provisions include: Section 9, 15 U.S.C. § 78i (liability for certain manipulations of securities traded on stock exchanges); Section 16, 15 U.S.C. § 78p(b) (liability for short-swing profits); Section 18, 15 U.S.C. § 78r (liability for misleading statements in certain periodic reports filed with the SEC); Section 20, 15 U.S.C. § 78t (liability for controlling persons); and Section 20A, 15 U.S.C. § 78t-1 (1994) (liability for insider-trading if plaintiff was a contemporaneous trader).

Id.

33. *See* Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Towards an Improved Analysis*, 126 U. PA. L. REV. 1345, 1345-51 (1978) [hereinafter *Secondary Liability*] ("These provisions were designed to reach situations in which there are technical legal barriers between the person in fact responsible for the violations of the securities acts and those injured by violations.").

primary violators of the Exchange Act.[34] Specifically, Section 20(a) of the Exchange Act holds liable those individuals who "control"—directly or indirectly—any person who may be liable for a violation of the provisions of the Exchange Act.[35]

Today, courts interpret the requirements for establishing a prima facie case of Section 20(a) liability differently.[36] The federal circuit courts, and district courts within the circuits, disagree over whether claims brought under Section 20(a) of the Exchange Act require proof of scienter.[37] The controversy has resulted in extensive case law examining the statute and its legislative history, as well as the development of majority

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34. Insider Trader and Securities Fraud Enforcement Act of 1988, H.R. REP. No. 910-100, at 27 n.23 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6064; *see also* Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973) (summarizing intent underlying addition of Section 20(a) to Exchange Act); 73 CONG. REC. 6571 (1934) (providing hearings before Commission on Banking and Currency); William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting Conspiracy, Controlling Person, and Agency: Common Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 363-64 (1989) (noting that controlling person provision in Securities Act sought to curb use of nominal, or "dummy," directors).

35. *See* 15 U.S.C. § 78t(a) (2000) (codifying controlling person liability under Exchange Act).

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Id.; *see also* 17 C.F.R. § 240.12(b)-2(f) (2000) (setting forth SEC definition of "control" for purposes of interpretation of Section 20(a)). "The term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise." *Id.* (internal quotations omitted) (parenthetical in original); *see also, e.g.*, Rochez Bros. v. Rhoades, 527 F.2d 880, 890 (3d Cir. 1975) (describing lack of statutory definition of "control"). "Congress deliberately did not define 'control,' thus indicating its desire to have the courts construe the applicable provisions of the statute along with the evidence adduced at trial." *Id. See generally* J. Christopher York, Comment, *Vicarious Liability of Controlling Persons: Respondeat Superior and the Securities Acts—A Reversible Consensus in the Circuits*, 42 EMORY L.J. 313, 319 (1993) (discussing negative effects of Congress's omission of statutory definition of control). "A wide variety of defendants have been held subject to liability under the controlling person doctrine, including stockholders, directors, corporate officers, employers, and partners." *Id.* at 315 n.10.

36. *Compare Rochez*, 527 F.2d at 890 (interpreting Section 20(a) to include culpable participation requirement), *with* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990) (en banc) (analyzing interpretation of Section 20(a)).

37. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 392-94 (framing issue regarding Section 20(a)); *see also* BLOOMENTHAL, *supra* note 14, at 1467-73 (explaining two different paths to "culpable participant" doctrine); Lockhart, *supra* note 15, § 4, at 205 (outlining case law and issues relevant to pleading fraud or state of mind).

and minority viewpoints.[38] The majority viewpoint states that culpability is part of the good faith defense expressly provided for in Section 20(a).[39] The minority viewpoint states that the plaintiff bears the burden of pleading the requisite state of mind of the controlling person—*equating scienter with culpable participation*—in order to establish the level of control necessary for Section 20(a) liability.[40] The court in *IPO Litigation* noted that resolving the scienter debate is central to determining the applicability of the heightened pleading standard of the PSLRA to Section 20(a) claims.[41]

B. *Background and Application of the PSLRA*

In 1995, Congress passed the PSLRA, overriding President Clinton's veto.[42] Supporters of the PSLRA touted the law as "a major victory for

38. *See* BLOOMENTHAL, *supra* note 14, at 1468-72 (outlining majority and minority viewpoints on controlling person liability); *see also, e.g.*, Brown v. Enstar Group, Inc., 84 F.3d 393, 396 (11th Cir. 1996) (examining statute and legislative history); Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992) (same); Cent. Bank of Denver, N.A. v. Pring, 969 F.2d 891, 896-97 (10th Cir. 1992) (same); *Hollinger*, 914 F.2d at 1575 (same); G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 958 (5th Cir. 1981) (same); *Rochez*, 527 F.2d at 890 (same).

39. *See* BLOOMENTHAL, *supra* note 14, at 1468-72 (explaining majority interpretation of Section 20(a)); *see also, e.g.*, *Hollinger*, 914 F.2d at 1575 (explaining majority interpretation and reasoning for adopting two-prong test). For a detailed discussion of the majority viewpoint, see *supra* notes 87-100.

40. *See Rochez*, 527 F.2d at 890 (explaining minority interpretation and reasoning for adopting three-prong test). For a detailed discussion of the minority viewpoint, see *supra* notes 59-86.

41. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 392-97 (analyzing requirements for prima facie case under Section 20(a)).

42. *See* 15 U.S.C. § 78u-4 (2000) (codifying PSLRA). For a discussion of the PSLRA's passage, see John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 335-37 (1996) (describing passage of PSLRA). The Senate voted on December 22, 1995, to overrule the presidential veto, following a similar vote by the House of Representatives two days earlier. *See id.* (discussing congressional override and legislation's impact). The President's veto message stated that the bill would "have the effect of closing the courthouse door on investors who have legitimate claims." *Id.* at 352; *see also* BLOOMENTHAL, *supra* note 14, at 1495 n.5 (outlining voting following President Clinton's veto message). The presidential veto did not change a single vote in the Senate. *See id.* (noting that sixty-five senators who originally voted for PSLRA were joined by three senators who originally abstained). For a detailed discussion of the legislative history of the PSLRA, see *id.* at 1268-69, 1495-96. *See generally* James V. Fazio III, *The Motive and Opportunity Test for Pleading Scienter Under the Federal Securities Laws: Where Is It Now?*, 50 FED. LAW. 51 (May 2003) (describing passage of PSLRA as bipartisan effort); Tamara Loomis, *Securities Fraud: Lawyers Seek Review of a Key Class Action Ruling*, N.Y.L.J., Oct. 26, 2000, at 5 (noting securities defense bar pushed hard for passage of PSLRA); Carl M. Cannon, *Letter from Washington; Suits v. Suits*, FORBES ASAP (Oct. 7, 2002), *at* http://www.forbes.com/asap/2002/1007/018.html (describing media focus on then President Clinton's ties to plaintiffs' attorney firm, Milberg, Weiss, Bershad, Hynes & Lerach, in response to veto of PSLRA). The media portrayed the PSLRA as "good government," but many practitioners remained concerned that the roaring economy largely influenced its passage. *See id.* (noting different views of PSLRA from media and trial lawyers). The Republican control of both houses of Congress in 1995 was a crucial

corporations over lawyers who filed . . . frivolous lawsuits, or 'strike suits.'"[43] The primary intent of the PSLRA may be best summarized by a caricature depicting a cow named "Litigation" being pulled at opposite ends by a plaintiff and a defendant, while the lawyer happily milks the cow.[44] This perception of securities litigation abuse dominated both the House and Senate debates following extensive testimony on the issue.[45] In response, Congress enacted the PSLRA with the hopes of limiting abuses in the system.[46] Yet, contrary to popular opinion in Congress, many questioned the validity of the threat to the securities litigation system.[47] Moreover, fears existed that the passage of the PSLRA would lead

component in the passage of the PSLRA. *See* William S. Lerach, *The Chickens Have Come Home to Roost: How Wall Street, the Big Accounting Firms and Corporate Interests Chloroformed Congress and Cost America's Investors Trillions* (2002), *at* http://www.enronfraud.com/pdf/chickens.pdf (discussing historical and political context surrounding passage of PSLRA).

43. Lori Calabro, *I Told You So* (Sept. 1, 2002), *at* http://www.cfo.com/article/1,5309,7612,00.html?f=related (describing PSLRA and initial reaction by many following passage). For a further discussion on strike suits, see Tim Oliver Brandi, *The Strike Suit: A Common Problem of the Derivative Suit and the Shareholder Class Action*, 98 DICK. L. REV. 355 (1994).

44. *See* BLOOMENTHAL, *supra* note 14, at 1268 (describing oft-cited sketch underlying intent of PSLRA). Senator Bennett argued the concepts described in the sketch by creating a similar picture with words on December 5, 1995. *See id.* (describing Senator Bennett's description of securities fraud class actions as dominated by "professional plaintiffs" with little equity in defendant corporation).

45. *See Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., and Urban Affairs*, 103d Cong. 1 (1994) [hereinafter *Subcommittee Hearing*] (describing purpose of PSLRA and findings from lengthy hearings regarding private securities litigation abuses). Senator Dodd, Chairman of the Securities Subcommittee, described the importance of maintaining an effective litigation system in order to preserve the integrity of the capital markets. *See id.* at 17-23 (summarizing testimony given by investors, accountants, executives and attorneys); *see also* Private Securities Litigation Reform Act of 1995, S. REP. NO. 104-98, at 9 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 687-88 [hereinafter *Senate Report*] (detailing studies supporting perception of out-of-control securities litigation and noting negative implications for capital markets). "The fact that many of these lawsuits are filed as class actions has had an in terrorem effect on Corporate America." *Id.*

46. *See In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 531 (3d Cir. 1999) (describing abuses targeted by PSLRA). The court stated:

> The purpose of the Act was to restrict abuses in securities class-action litigation, including: (1) the practice of filing lawsuits against issuers of securities in response to any significant change in stock price, regardless of defendants' culpability; (2) the targeting of "deep pocket" defendants; (3) the abuse of the discovery process to coerce settlement; and (4) manipulation of clients by class action attorneys.

Id.

47. *See* Avery, *supra* note 42, at 339-40 (describing testimony given by many as anecdotal). The author stated that much of the empirical evidence regarding the widespread abuses in the private litigation system was inconclusive. *See id.* (noting that evidence did not demonstrate that warrantless class action suits had exploded); *see also Subcommittee Hearing*, *supra* note 45, at 167-69 (summarizing conclusions about abuse of private securities litigation based on testimony from

to increases in securities fraud and investor losses.[48] Irrespective of the conclusions regarding the securities litigation explosion, the enactment of the PSLRA was an extraordinary event in the history of securities regulation.[49] Its passage represented a major shift away from investor protection.[50]

Based on the perception of abuse of the securities litigation system and perceived increase in private securities litigation, the PSLRA codified several heightened pleading requirements.[51] Congress recognized the varied pleading standards being applied to claims of securities fraud in the

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investors, corporate executives, accountants and attorneys). Much of the evidence relied upon by the congressional committees has been subjected to criticism. *See generally* William S. Lerach et al., *Sea Changes in Private Litigation: Securities Class Action Litigation Reform Act of 1995*, SC09 A.L.I.-A.B.A. 439 (July 24, 1997) (describing Congress's heavy reliance on Janet Cooper Alexander's study on securities litigation settlements in connection with passage of PSLRA) (citing Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991)).

48. *See* Lerach, *supra* note 42 (explaining that consumer, worker and investment groups warned of potentially negative effects of PSLRA).

49. *See* BLOOMENTHAL, *supra* note 14, at 1495 (describing significance of passage of PSLRA in historical context of securities regulation). "The Private Securities Litigation Act is now the law of the land. This is the most momentous event in the history of securities regulation since the adoption of the Securities Acts in 1933 and 1934." *Id.*

50. *See id.* (describing shift in attitude towards investors expressed within PSLRA). "The act is likely to be seen in retrospect as a defining moment in which the Securities Acts veered from an emphasis on investor protection to investor beware." *Id.* "The procedural barriers which the '95 [PSLRA] . . . Act installed to obstruct plaintiffs seeking relief under federal securities laws seriously eroded investor protection." Mark Klock, *Lighthouse or Hidden Reef? Navigating the Fiduciary Duty of Delaware Corporations' Directors in the Wake of* Malone, 6 STAN. J.L. BUS. & FIN. 1, 36 (2000) (describing PSLRA's adverse effect on investor protection). Specifically, critics point to the application of the PSLRA in the Ninth Circuit as a representation of the negative implications for investors. *See* Lerach, *supra* note 42 (detailing historical use of PSLRA in Ninth Circuit). "Seventeen times in a row, using the PSLRA, th[e Ninth Circuit] has sided with corporate interests and closed the courthouse door to defrauded investors." *Id.*

51. *See Senate Report*, *supra* note 45, at 4 (describing purpose and summary of PSLRA). Congress referenced substantial testimony heard before it that described plaintiffs' lawyers filing suits alleging securities violations merely in the hope that defendants would settle quickly. *See id.* (describing consequences of "strike" suits as chilling corporate disclosures and increasing cost of raising capital). The House and Senate Committees were provided with evidence regarding the filing of strike suits. *See* H.R. CONF. REP. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730 (describing testimony provided regarding abusive practices prevalent in strike suits). The abusive practices committed in private securities litigation include:

> [T]he routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the discovery process might lead eventually to some plausible cause of action . . . (and) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability.

circuit courts and attempted to create uniform pleading standards.[52] Specifically, if the claim involves a "state of mind" element, the PSLRA requires application of more stringent pleading requirements.[53]

Nonetheless, the pleading requirements established in 1995 remain controversial; circuit courts, and district courts within many circuits, disagree about the proper interpretation of the pleading requirements.[54] Fur-

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Id. at 730; *see also* Avery, *supra* note 42, at 353-54 (describing measures implemented by PSLRA to deter meritless litigation).

52. *See* 15 U.S.C. § 78u-4(b)(1) (2000) (setting forth heightened pleading requirements). Specifically, this Note addresses Paragraph (b)(2) that establishes heightened pleading requirements in private actions in which the plaintiff may recover money damages only if the defendant acted with the required state of mind. Paragraph (b)(1) provides in pertinent part:

> In any private action arising under this chapter in which the plaintiff alleges that the defendant (a) made an untrue statement of a material fact; or (b) omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reasons or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

Id. Paragraph (b)(2) provides in pertinent part:

> In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

Id.; *see also In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 329-31 (S.D.N.Y. 2003) (describing Paragraphs (b)(1) and (b)(2) of PSLRA). *But see* Loomis, *supra* note 42 (noting disagreement among circuits regarding pleading requirements under PSLRA). "Five years later [in 2000], if anything, the stated goals of the Reform Act seem more elusive than ever." *Id.*

53. *See* Denis T. Rice, *A Practitioner's View of the Securities Litigation Reform Act of 1995*, 31 U.S.F. L. REV. 283, 323 (1997) (noting that PSLRA requires "higher standard of pleading fraud by private plaintiffs . . . than most courts have recognized under the Federal Rules of Civil Procedure"); *see, e.g.*, Mishkin v. Ageloff, No. CIV.97-2690-LAP, 1998 WL 651065, at *24 (S.D.N.Y. Sept. 23, 1998) (holding that "a plaintiff must come forward with 'proof that the defendant acted with a particular state of mind'").

54. *See* Loomis, *supra* note 42, at 5 (outlining circuit split regarding heightened pleading requirements set forth in PSLRA). The Ninth and Second Circuit interpretations are at "opposite ends of the spectrum," while the First, Third, Sixth and Eleventh Circuit interpretations are between the two extremes. *See id.* (noting that various interpretations of scienter requirement have undermined Congress's intent for PSLRA to act as "sure-fire deterrent to securities class actions nationwide"); *see also In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393 (describing circuit split over whether Section 20(a) has scienter requirement forcing application of PSLRA). *Compare In re* CINAR Corp. Sec. Litig., 186 F. Supp. 2d 279, 310 (E.D.N.Y. 2002) (declining to require a showing of culpable participation), *with In re* Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741, 770 (S.D.N.Y. 2001) (requiring a showing of culpable participation). *See generally* Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627 (2002) (provid-

thermore, many still criticize the PSLRA's shift away from investor protection.[55] Some consumer groups have even called for a repeal of the PSLRA, while many argue there is no connection between the PSLRA and recent scandals.[56] Efforts to amend, or even repeal, the PSLRA have subsided, but whether the judiciary will limit the power of the PSLRA by narrowing its application remains to be seen.[57] The holding in *IPO Litigation*

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ing detailed analysis of interpretations of PSLRA). For analysis of post-PSLRA class action securities litigation, see Cornerstone Research, *Securities Class Action Case Filings, 2002: A Year in Review, available at* http://securities.cornerstone.com/ (last visited Jan. 28, 2004) (providing detailed analysis of class action securities litigation following enactment of PSLRA). *See generally* Elaine Buckberg et al., *Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides?* (June 2003), *available at* http://www.nera.com/wwt/publications/6143.pdf (providing detailed data and analysis on securities class action litigation trends regarding PSLRA); *id.* at 12 (concluding, based on research, that plaintiffs' bar is pursuing fraud more aggressively since passage of PSLRA); Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2002, available at* http://www.cornerstone.com/fram_res.html (last visited Jan. 28, 2004) (providing data on settlements from enactment of PSLRA through 2001). Controlling for the number of public companies in each year, "the likelihood of a public company being sued rose approximately 40% from 1995 to 2002." *Id.*

55. *See* Adam C. Pritchard, *Should Congress Repeal Securities Class Action Reform?*, POL'Y ANALYSIS, Feb. 27, 2003, at 1 (describing "drumbeat" for examination of PSLRA and strengthening of plaintiffs' bar). The author noted that calls for the repeal of the PSLRA have increased following the recent spate of fraudulent behavior at several high profile companies. *See id.* at 11 (noting calls for repeal despite evidence showing that reform has encouraged lawyers to target suits more precisely and has reduced costs of defending meritless claims); *see also* Calabro, *supra* note 43, at 3 (quoting William Lerach, name partner at Milberg, Weiss, Bershad, Hynes & Lerach). "[T]here is no question that the '95 Act [PSLRA] emboldened executives to think they could do whatever they wanted." *Id.*; *see also* Cannon, *supra* note 42 (noting Congress revisited PSLRA following Enron collapse). Specifically, several Democrats in the Senate explored amending the PSLRA, but other legislative matters diverted their attention. *See id.* (noting that Congress turned its attention to increasing corporate responsibility and strengthening SEC powers).

56. *See* Press Release, Consumer Federation of America (Feb. 15, 2002), *at* http://www.consumersunion.org/finance/securdc202.htm (urging Congress to restore investor confidence by amending PSLRA). "These pleading rules have been set up to shield wrongdoers from accountability for fraudulent activity." *Id. But see* Steve Krausz, *Don't Scapegoat Securities Litigation Reform for the Enron Debacle*, STAN. L. SCH. SEC. CLASS ACTION CLEARINGHOUSE (Apr. 1, 2002), *at* http://securities.stanford.edu/news-archive/2002/20020401_Headline03_Krausz.htm (describing calls for amendment of PSLRA "one really bad idea"); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 914 (2002) (describing debate over role PSLRA played in Enron scandal). "In my view, there is absolutely no connection that has been shown between the collapse of Enron and the Private Securities Litigation Reform Act, absolutely none." Rachel McTague, *Pitt Says Don't Change Independence Rules, Favors Much of the House Reform Bill*, 34 Sec. Reg. & L. Rep. (BNA) 488 (2002) (quoting Harvey Pitt, former SEC chairman).

57. *See* Krausz, *supra* note 56 (explaining dissipation of calls for amendment or repeal of PSLRA); *see also* Pritchard, *supra* note 55, at 12 (describing impact of PSLRA on class action litigation).

may support the argument that the PSLRA is being applied more grudgingly in the wake of recent corporate scandals.[58]

C. *The Inter- and Intra-Circuit Splits*

1. *The Minority's Three-Part Test*

The minority view requires satisfaction of three components to adequately plead a Section 20(a) claim: (1) an underlying primary violation of the securities laws by the controlled person; (2) control over the controlled person; and (3) a showing that the controlling person was, in some meaningful sense, a culpable participant in the controlled person's primary violation.[59] Significantly, the minority's three-part test requires that the allegations contain sufficient facts to show that the controlling person was a culpable participant in the underlying violation.[60] The number of circuits supporting this view has declined in recent history, with only the Third and Fourth Circuits retaining the minority's three-prong test.[61] Despite the decline in support for the minority view, the issue remains un-

58. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (holding that Section 20(a) allegations do not fall under PSLRA's heightened pleading requirements); *cf.* Stephen Labaton, *Now Who, Exactly, Got Us into This?*, N.Y. TIMES, Feb. 3, 2002, § 3, at 1 (fearing PSLRA may present obstacle to investors seeking damages). It is important to note that the factual circumstances underlying the Section 20(a) claims in *In re Initial Public Offering Securities Litigation* may have made it easier for the court to avoid application of the heightened pleading standards contained in the PSLRA. *See* 241 F. Supp. 2d at 395 n.183 ("[E]ven if 'culpable participation' did entail scienter, Plaintiffs have pleaded it here with respect to those Individual Defendants liable under Rule 10b-5.").

59. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393-96 (discussing requirements for "culpable participation" with respect to Section 20(a)).

60. *See id.* at 393 (announcing minority view with respect to Section 20(a)); Lewis D. Lowenfels & Alan R. Bromberg, *Controlling Person Liability Under Section 20(a) of the Securities Exchange Act and Section 15 of the Securities Act*, 53 BUS. LAW. 1, 6-7 (1997) (describing minority and majority interpretations of Section 20(a)). The minority view, by including culpable participation in Section 20(a), requires a state of mind component, and there has been extensive debate over whether this mental state equates to scienter. *See* Gabriel Capital, L.P. v. NatWest Fin., Inc., 122 F. Supp. 2d 407, 427-28 (describing argument raised by defendants that culpable participation should receive scienter standard similar to allegations raised under Section 10b-5 of Exchange Act). *See generally* Michael A. Dorelli, Note, *Striking Back at "Extortionate" Securities Litigation:* Silicon Graphics *Leads the Way to a Truly Heightened and Uniform Pleading Standard*, 31 IND. L. REV. 1189 (1998) (discussing various standards applied to satisfy scienter in context of securities litigation and controlling person liability).

61. *See, e.g.*, Carpenter v. Harris, Upham & Co., 594 F.2d 388, 393-94 (4th Cir. 1979) (describing plaintiff's pleading requirement as something more than negligence); Rochez Bros. v. Rhoades, 527 F.2d 880, 889-90 (3d Cir. 1975) (holding in favor of three-prong test). The court in *Carpenter* relied heavily on cases supporting the minority view and, therefore, is typically viewed as supporting the three-prong test. *See id.* at 394 (noting intent of Congress to limit liability to controlling persons) (citing Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973)).

resolved among the circuit courts, and most notably among district courts within the Second Circuit.[62]

The Third Circuit supports the minority view with respect to the pleading requirements under Section 20(a).[63] In *Rochez Brothers, Inc. v. Rhoades*,[64] the president and director of a private corporation purchased fifty percent of the issued and outstanding stock of the corporation from the corporation's vice president without disclosing material information pertinent to the price of the stock.[65] The president's violation rested on the failure to relay information to the vice president regarding possible purchasers of the corporation.[66] Relying on a finding of wrongdoing on the part of the president, the vice president attempted to apply Section 20(a), seeking to expand liability to the corporation.[67] The Third Circuit relied on two holdings—one from the Second Circuit and one from the Southern District of New York—in determining that culpability of a controlling person must be proven to impose liability.[68] This holding argua-

62. *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990) (en banc) (providing example of circuit switching from minority to majority view despite view within circuit that issue was settled); *see also* Richard L. Levine & Nader Mobargha, *The Culpable Conduct Requirement in Control Person Claims*, BUS. SEC. LITIGATOR (Sept. 2001), *available at* http://www.weil.com/wgm/cwgmhomep.nsf/Files/BSL_Sept/$file/BSL_Sept.pdf (predicting in 2001 that Second Circuit will adopt minority's three-prong test). The authors' prediction conflicts with the holding in *In re Initial Public Offering Securities Litigation*. *See id.* (noting split among Second Circuit district courts regarding what must be alleged to state claim under Section 20(a)). "A number of district courts in the Second Circuit had taken the position that *Lanza* required plaintiffs to establish culpable participation in order to establish liability under Section 20(a). A number of other district courts in the Second Circuit held to the contrary." BLOOMENTHAL, *supra* note 14, at 1470-71.

63. *See generally* Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974) (requiring establishment of controlling person's state of mind in order to assess liability under Section 20(a)).

64. *See Rochez*, 527 F.2d at 884-85 (requiring culpable participation for liability under Section 20(a)).

65. *See id.* at 883 (describing facts of case). *See generally* Lowenfels & Bromberg, *supra* note 60, at 22 (summarizing facts of case).

66. *See Rochez*, 527 F.2d at 883 (providing background information on case). The issue before the court was whether a corporation is derivatively liable when its president has violated the Exchange Act. *See id.* at 883 (discussing facts of case). Initially, the U.S. District Court for the Western District of Pennsylvania entered judgment in favor of the president, and the vice president appealed. *See id.* at 883 (reciting procedural history).

67. *See id.* at 891 (explaining potential controlling person liability exposure for corporation but denying to extend it).

> Even if we were to determine that MS&R was the "controlling person," we accept the district court's findings that MS&R acted in good faith and did not directly or indirectly induce the acts . . . . Having expressed the necessity of showing culpable participation, we need not further burden the opinion with more discussion.

Id.

68. *See id.* at 890 (relying on Gordon v. Burr, 366 F. Supp. 156 (S.D.N.Y. 1973)). The court held that controlling person liability cannot be found in the event there is no knowledge or culpable participation on the part of the control-

bly placed the Third Circuit in the minority even though the court did not directly address the pleading requirements under Section 20(a).[69]

Based almost entirely on interpretations of the legislative history of Section 20(a), the court in *Rochez* stated that Congress intended to require culpability in order to impose liability on a controlling person for the underlying securities law violations.[70] The court's argument in favor of this conclusion was that Congress did not intend to make someone an insurer for the fraudulent activities of another.[71] The court further analogized the legislative intent underlying Section 15 of the Securities Act to that of Section 20(a), noting that Section 20(a) was modeled after the Securities Act.[72] This comparison bolstered the court's holding that findings of liability require more than mere control.[73]

Despite the Third Circuit's analysis of the legislative history of Section 20(a) and its reliance on the holdings in *Lanza v. Drexel & Co.*[74] and

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ling person. *See id.* (upholding lower court ruling). Consistent with the minority view, the court noted that "[i]naction alone cannot be a basis for liability." *Id.*

69. *See* BLOOMENTHAL, *supra* note 14, at 1470 (noting Third and Fourth Circuit's minority interpretation of "culpable participation" as element of "control"). *But see* Levine & Mobargha, *supra* note 62, at 3 (explaining that cases relying on *Lanza* arguably misinterpret holding in that case). Neither *Lanza* nor *Gordon* dealt with the pleading stage, but instead were describing the elements required to *prove* a Section 20(a) claim. *See id.* (noting neither *Lanza* nor *Gordon* addressed whether plaintiff must plead culpability).

70. *See Rochez*, 527 F.2d at 889-90 (comparing interpretations of legislative history of Exchange Act). The court noted that it was unable to find anything that would lead it to believe that Congress's intent in creating liability under the Securities Act was different from the creation of liability under Section 20(a). *See id.* at 890 (noting proof of culpability required to impose liability).

71. *See id.* at 890 (describing negative result if culpability not required in establishing controlling person liability); *see also In re* Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 416 (S.D.N.Y. 2001) (affirming burden on plaintiff to plead culpable participation despite good faith defense). *But see* BLOOMENTHAL, *supra* note 14, at 1469-70 (describing Section 20(a) as redundant if culpability and good faith defense co-exist). Criticizing the holding in *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 715-16 (2d Cir. 1980), the author argues that the good faith defense provided in Section 20(a) eliminates the potential for making someone an insurer against the securities violations of another. *See id.* at 1474 (noting that respondeat superior doctrine may impose liability in absence of culpability).

72. *See* SEC v. Mgmt. Dynamics, Inc., 515 F.2d 801, 812 (2d Cir. 1975) (noting purpose of both Sections 15 and 20(a) was to prevent directors from evading liability); H.R. CONF. REP. NO. 152-73, at 27 (1933) (noting that Senate draft of Securities Act proposed "insurer's liability" standard). The Senate version, however, was not adopted. *See Rochez*, 527 F.2d at 885 (noting House draft proposed fiduciary standard imposing liability only on controlling persons who breached duty of care); *see also* H.R. CONF. REP. NO. 152-73, at 27 (1933) (detailing legislative history of House version of Section 15 of Securities Act). For a general discussion on the legislative history of the Securities Act, see James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

73. *See Rochez*, 527 F.2d at 890 (comparing similar intent underlying creation of Section 15 of Securities Act and Section 20 of Exchange Act).

74. 479 F.2d 1277 (2d Cir. 1973).

Gordon v. Burr,[75] *Rochez* provides limited guidance in analyzing the holding in *IPO Litigation*.[76] The court in *Rochez* did not define "culpable participation," and the case was decided prior to the enactment of the PSLRA.[77] The significance of the holding in *Rochez* is that it appeared to uphold the three-prong test and, therefore, arguably established precedent for requiring the application of the PSLRA to Section 20(a) claims.[78]

The Fourth Circuit arguably upheld the minority view with respect to the pleading requirements set forth under Section 20(a).[79] In *Carpenter v. Harris, Upham & Co.*,[80] the court heard appeals from a summary judgment order granted pursuant to an action against a securities brokerage firm.[81] The purchasers attempted to establish that the brokerage firm was a controlling person, as defined by the Exchange Act, in an effort to expose the firm to liability and recover losses suffered as a result of their purchases.[82] The *Carpenter* court held, however, that the brokerage firm was not liable under Section 20(a).[83] The Fourth Circuit's reliance on *Lanza* and its interpretation of the legislative history of Section 20(a) in *Carpenter* favor the

75. 366 F. Supp. 156 (S.D.N.Y. 1973).

76. *See Rochez*, 527 F.2d at 890 (describing interpretations of legislative intent in Second Circuit cases).

77. *See id.* (requiring plaintiff to show that defendant was culpable participant, but failing to define term). The court offered no definition of the term throughout the entire opinion. *See In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 393 n.179 (S.D.N.Y. 2003) (noting holding in *Rochez* requires, but does not define, culpable participation).

78. *Compare In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396-97 (addressing application of PSLRA to Section 20(a)), *with* Mishkin v. Ageloff, No. CIV.97-2690-LAP, 1998 WL 651065, at *24 (S.D.N.Y. Sept. 23, 1998) (same). Relying on these two cases, the argument with respect to *Rochez* would be that its adoption of the minority view would result in the application of the PSLRA for the same reasons set forth in *Mishkin*. *See Mishkin*, 1990 WL 651065, at *24-25 (requiring person to have control over controlled person and showing of conscious misbehavior to show controlling person was "a culpable participant in the fraud" perpetrated by controlled person under Section 20(a)).

79. *See* Carpenter v. Harris, Upham & Co., 594 F.2d 388 (4th Cir. 1979) (requiring proof of something more than negligence to establish controlling person liability); *see also* Lowenfels & Bromberg, *supra* note 60, at 25 (noting *Carpenter* could support either majority or minority viewpoint). "A leading case in the Fourth Circuit . . . can be interpreted with equal facility either to require or not to require 'culpable participation.'" *Id.*

80. 594 F.2d 388 (4th Cir. 1979).

81. *See id.* at 390 (describing facts and procedural history of case). The purchasers sought to hold Harris, Upham liable for losses incurred as a result of the purchase of unregistered securities through one of Harris's employees. *See id.* at 390 (outlining facts of case).

82. *See id.* at 390-91 (outlining allegations raised by appellants and procedural history of case). The district court granted summary judgment, holding that there was "no theory which would support a judgment against Harris, Upham based on actions taken by [the employee] after he left the firm's employ." *Id.* at 390 (concluding defendant was not "controlling person" under Section 20).

83. *See id.* at 393-94 (holding controlling person provision contains state of mind condition). The *Carpenter* court held that satisfaction of the state of mind condition requires something "more than negligence to establish liability." *See*

minority view.[84] Specifically, the Fourth Circuit adopted an approach similar to the Third Circuit's approach in *Rochez*, holding that the intent underlying Section 20(a) was not to create an insurer's liability standard.[85] Notwithstanding the holding in *Carpenter*, however, proponents of the majority view cite subsequent Fourth Circuit holdings in support of their position.[86]

2. *The Majority's Two-Part Test*

The majority view only requires satisfaction of two components to adequately plead Section 20(a) claims: (1) control by the controlling person over the individual alleged to have violated the Exchange Act and (2) a violation by the controlled individual.[87] Specifically, the plaintiff must initially plead that the controlling person actually had "control" and that

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BLOOMENTHAL, *supra* note 14, at 1470 (describing Third and Fourth Circuit interpretations of culpable participation, as aspect of control).

84. *See Carpenter*, 594 F.2d at 394 (describing intent of Congress in creating controlling person liability). "Clearly Congress had rejected an insurer's liability standard for controlling persons in favor of a fiduciary standard." *Id.*; *see also* Rochez Bros. v. Rhoades, 527 F.2d 880, 890 (3d Cir. 1975) (interpreting legislative history similarly).

85. *Compare Rochez*, 527 F.2d at 889-90 (arguing that Congress was "unlikely to permit[ ] liability to be found on something other than culpable participation"), *with Carpenter*, 594 F.2d at 393-94 (highlighting similarities in interpreting requirements for controlling person liability). The court in each case addressed the exculpatory clause provided in Section 20(a) and held that its inclusion demanded more than mere control in order to find controlling person liability. *See id.* (noting requirements of controlling person provisions). Neither court, however, associated this heightened requirement with the defendant's burden of proof. *See id.* (placing burden of proof on plaintiff to establish liability). Instead, both courts appear to require the plaintiff to allege culpable participation. *See Rochez*, 527 F.2d at 889 (noting requirement that plaintiff show wrongdoing). *But see* Paul F. Newton & Co. v. Tex. Commerce, 630 F.2d 1111, 1115-18 (5th Cir. 1980) (providing extensive analysis on controlling person provisions and legislative history). The Fifth Circuit in *Newton* held that "[t]he inconclusive legislative history of §§ 15 and 20(a) supports neither of the positions advocated by the parties before us on this appeal." *Id.* at 1116.

86. *See, e.g.*, Hunt v. Miller, 908 F.2d 1210 (4th Cir. 1990) (interpreting *Carpenter* as not requiring culpable participation in controlling person liability claims). The *Carpenter* court noted that the plaintiff is only required to allege that the controlling person failed to maintain an adequate system of internal control or that the controlling person failed to maintain the system in a diligent manner. *See id.* at 1215 (explaining holding in *Carpenter*). *But see Carpenter*, 594 F.2d at 394 (describing holding with respect to controlling person liability and explaining requirements for establishment of good faith defense). The court's continuation of its reasoning with respect to the exculpatory clause could be used to support the majority view that Section 20(a) claims are bifurcated. *See id.* (requiring elements of control as well as affirmative actions to avoid violation of securities laws). The court stated, "In order to satisfy the requirements of good faith it is necessary for the *controlling person*, i.e., the defendant, to show some precautionary measures were taken to prevent an injury caused by an employee." *Id.* at 394 (emphasis added).

87. *See generally* BLOOMENTHAL, *supra* note 14, at 1470 (describing two-prong majority test); *see also, e.g.*, *In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d

there was a primary violation by the individual under the "control" of the Section 20(a) defendant.[88] Interestingly, under the majority view, courts have held that the burden shifts to the defendant to exculpate himself from liability by demonstrating good faith, or lack of involvement in the underlying securities violation.[89] The pleading scenario would thus involve the plaintiff pleading control and an underlying violation (the initial two components noted above) followed by an opportunity for the defendant to establish an affirmative defense of good faith.

In assessing whether there is a state of mind requirement in Section 20(a), a crucial distinction between the majority and minority views is, therefore, the interpretation of the exculpatory good faith clause contained in Section 20(a).[90] Those courts upholding the majority view argue that requiring the third prong of the minority test—that the controlling person was, in some meaningful sense, a culpable participant in the controlled person's primary violation—is unnecessary given the existence of the good faith escape hatch in Section 20(a).[91] This interpretation results in the collapse of the culpable participation requirement and removes Section 20(a) from the heightened pleading standards set forth under the PSLRA.[92] The basis for this collapse of the culpable participation compo-

281, 396 (S.D.N.Y. 2003) (requiring defendant to show either good faith or due diligence for exculpation).

88. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 394-95 (outlining requirements for pleading case under Section 20(a)).

89. *See* BLOOMENTHAL, *supra* note 14, at 1469 (explaining majority view with respect to good faith provision).

> Finding that the defendant controlled the primary violator, of course, is not dispositive as the defendant still has a good faith defense under Section 20(a). It is of considerable practical significance, however, as it shifts the burden of proof and, therefore, among other things, makes it more difficult for a controlling person to obtain a summary judgment.

Id.

90. *See* Lowenfels & Bromberg, *supra* note 60, at 26 (outlining majority view and emphasis on role of exculpatory clause). The authors noted that once control status and an underlying violation have been established by the plaintiff, the burden then shifts to the defendant to demonstrate good faith under Section 20(a). *See id.* (noting controlling person is liable unless controlling person acted in good faith); *see also, e.g., In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (noting that proving scienter is required only if defendant presents affirmative defense of good faith); *In re* Health Mgmt., Inc. Sec. Litig., 970 F. Supp. 192, 206 (E.D.N.Y. 1997) (describing culpability as element of affirmative defense by defendant).

91. *See* BLOOMENTHAL, *supra* note 14, at 1468 (describing good faith provision provided in Section 20(a)). The author points out that the reluctance to strictly enforce controlling person liability under Section 20(a) ignores the fact that "Section 20(a) allows the controlling person to exculpate himself/herself/itself by showing that s/he/it did not induce the violation and acted in good faith." *Id.*; *see, e.g.*, Marbury Mgmt., Inc. v. Kohn, 629 F.2d 705 (2d Cir. 1980) (supporting incorporation of culpability in good faith defense instead of plaintiff's pleading requirements).

92. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281 at 396 (outlining implications for PSLRA if Section 20(a) does not contain state of mind pleading requirement).

nent is the elimination of the requirement that the plaintiff ultimately prove the defendant's state of mind.[93] The two-prong test appears firmly established in the circuits currently composing the majority, despite these courts' initial support of the minority view.[94]

The Ninth Circuit's holding in 1990 evidences the increasing dominance of the majority view.[95] Overruling two of its earlier decisions, the Ninth Circuit in *Hollinger v. Titan Capital Corp.*[96] "return[ed] to what had once been the law" and reached a different conclusion with respect to the pleading requirements set forth under Section 20(a).[97] The court in *Hollinger* took exception to its earlier interpretation of the provisions contained in Section 20(a) and renewed its evaluation of the requirements set forth under Section 20(a), paying particular attention to the good faith clause.[98] Responding to fears that this bifurcated interpretation of Sec-

93. *See id.* (same); *see also* 15 U.S.C. § 78u-4(b)(2) (2000) (establishing requirement that heightened pleading standard contained in PSLRA applies in situations in which plaintiff can ultimately recover money damages only on proof of defendant's state of mind).

94. *Compare* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1574-75 (9th Cir. 1990) (holding that broker dealer liability does not require showing of culpable participation), *cert. denied*, 499 U.S. 976 (1991), *with* Buhler v. Audio Leasing Corp., 807 F.2d 833 (9th Cir. 1987) (holding in favor of culpable participation requirement); *see also* Lockhart, *supra* note 15, at 185 (listing cases in Ninth Circuit related to issue).

95. *See Hollinger*, 914 F.2d at 1574-75 (shifting Ninth Circuit's stance regarding culpable participation requirement). "Today, however, we hold that a plaintiff is *not* required to show 'culpable participation' to establish that a broker-dealer was a controlling person under § 20(a)." *Id.*; *see also* Lowenfels & Bromberg, *supra* note 60, at 25-26 (describing Ninth Circuit's switch to majority "camp" in 1990).

96. 914 F.2d 1564 (9th Cir. 1990).

97. *Id.* at 1575 (recognizing previous stance and placing burden of pleading on defendant to prove good faith under Section 20(a)); *see also* Christoffel v. E.F. Hutton & Co., 588 F.2d 665, 668-69 (9th Cir. 1978) (supporting minority view prior to *Hollinger*). *See generally* BLOOMENTHAL, *supra* note 14, at 1469 (describing steps taken by court to clarify culpable participation doctrine). The author argues that the issue of culpable participation became "entwined" with the issue whether an individual is a controlling person. *See id.* (explaining that *Hollinger* decision allowed continued confusion regarding culpable participation requirement). The Ninth Circuit used *Hollinger* to repudiate any prior holdings upholding this interpretation of Section 20(a). *See id.* (same).

98. *See Hollinger*, 914 F.2d at 1575 (explaining reversal with respect to interpretation of legislative history and intent underlying Section 20(a)). The court summarized its latest interpretation by saying, "[Section 20(a)] premises liability solely on the control relationship, subject to the good faith defense. According to the statutory language, once the plaintiff establishes that the defendant is a 'controlling person,' then the defendant bears the burden of proof to show his good faith." *Id. But see Buhler*, 807 F.2d at 835-36 (describing matter of culpability as settled). "Given that the securities laws in general were meant to impose liability only on culpable parties with enforceable control, . . . we continue to adhere to our prior holdings that the common law is supplanted by sections 15 and 20." *Id.* at 836. *See generally* York, *supra* note 35, at 340-45 (describing holding in *Hollinger* as capitulation of Ninth Circuit). The minority view appeared firmly established in the Ninth Circuit until *Hollinger*. *See id.* at 340 (noting that minority rule developed over twenty-year period). The author argues that the holding in the Ninth

tion 20(a) would create an insurer's liability standard, as alluded to in *Rochez* and *Carpenter*, the court in *Hollinger* relied on the strength of the exculpatory clause contained in Section 20(a).[99] The court in *Hollinger* held that "a plaintiff is not required to show 'culpable participation' to establish that a broker-dealer was a controlling person under § 20(a)."[100]

3. *The Split Between District Courts in the Second Circuit*

The Second Circuit has not definitively answered the question whether a plaintiff must *plead* a culpable state of mind in connection with an alleged violation under Section 20(a) of the Exchange Act.[101] The failure to express a clear holding with respect to the pleading requirements under Section 20(a) has resulted in a split among the district courts within the Second Circuit.[102] This division

Circuit was "the result of a decision to conform." *See id.* (stating that court acknowledged it was joining several other circuits).

99. *See Hollinger*, 914 F.2d at 1575 (describing protections against liability contained in good faith defense clause). The court stated:

> The mere fact that a controlling person relationship exists does not mean that vicarious liability necessarily follows. Section 20(a) provides that the "controlling person" can avoid liability if she acted in good faith and did not directly or indirectly induce the violations. By making the good faith defense available to controlling persons, Congress was able to avoid what it deemed to be an undesirable result, namely that of insurer's liability, and instead it made vicarious liability under § 20(a) dependent upon the broker-dealer's good faith.

Id.

100. *Id.* (placing emphasis on good faith provision of Section 20(a)). "Section 20(a) provides that a 'controlling person' is liable 'unless [he/she/it] acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.'" *Id.* (bracketed text in original).

101. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393 (noting that Second Circuit has not ruled whether Section 20(a) has scienter element). *See generally* Levine & Mobargha, *supra* note 62 (discussing split within Second Circuit regarding pleading Section 20(a) claims). The authors note that the split within the Second Circuit has lasted for over a quarter of a century. *See id.* (same).

102. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 394 (explaining division and highlighting failed attempts to clarify issue within Second Circuit). "Nonetheless, after 1980, district courts were divided on whether Section 20(a) contained an element of scienter . . . ." *Id.*; *see also* Mishkin v. Ageloff, No. CIV.97-2690-LAP, 1998 WL 651065, at *23 (S.D.N.Y. Sept. 23, 1998) (noting divergent standards being applied to motions to dismiss Section 20(a) claims within Second Circuit). "Although one would think, and hope, that the standard to be applied in a motion to dismiss a [S]ection 20(a) claim is well-established, the opposite is all too unfortunately the case." *Id.* at *22; *see also, e.g.*, *In re* CINAR Corp. Sec. Litig., 186 F. Supp. 2d 279, 310 (E.D.N.Y. 2002) (representing Second Circuit holdings addressing issue whether plaintiffs must plead culpable participation when alleging Section 20(a) claims); *In re* Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741, 770 (S.D.N.Y. 2001) (same); Gabriel Capital, L.P. v. NatWest Fin., Inc., 122 F. Supp. 2d 407, 427 (S.D.N.Y. 2000) (same); *In re* Twinlab Corp. Sec. Litig., 103 F. Supp. 2d 193, 208 (E.D.N.Y. 2000) (same); *In re* Livent Inc. Sec. Litig., 78 F. Supp. 2d 194, 221-22 (S.D.N.Y. 1999) (same); Ellison v. Am. Image Motor Co., 36 F. Supp. 2d 628, 637 (S.D.N.Y. 1999) (same); *Mishkin*, 1998 WL 651065, at *24 (same); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179,

reflects the deep division among the various circuits, as discussed above.[103]

In one line of cases, district courts have held that the plaintiff must plead a violation by the controlled person, control over such person and culpable participation in the fraud alleged in order to satisfy the requirements under Section 20(a).[104] More succinctly, this line of cases, relying on the holding in *Lanza*, requires that the plaintiff plead culpability instead of placing this burden on the defendant as an affirmative defense.[105] Courts have subjected *Lanza* and its progeny to various interpretations; however, as recently as September 2003, the Eastern District of New York used the three-prong test, evidencing the test's continued vitality.[106]

A separate line of cases within the Second Circuit upholds the majority rule, requiring only that the plaintiff plead an allegation of control and an underlying violation.[107] This line of cases, adopting the majority's two-part test and the holding in *Marbury Management v. Kohn*,[108] is relied on by, and consistent with, the holding in *IPO Litigation*.[109] As with the minority analysis, the key issue is whether the plaintiff or the defendant, through the exculpatory clause within Section 20(a), has the burden of

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1194-95 (S.D.N.Y. 1981) (same). *See generally In re* Health Mgmt., Inc. Sec. Litig., 970 F. Supp. 192, 206 (E.D.N.Y. 1997) (providing extensive discussion on split within Second Circuit).

103. For a further discussion on the division between the federal circuit courts, see *supra* notes 59-100.

104. *See* Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973) (explaining intent of Congress in adopting Section 20(a)); *see also* Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974) (same).

> The intent of Congress in adding [Section 20], passed at the same time as the amendment to Section 15 of the 1933 Act, was obviously to impose liability only on those directors who fall within its definition of control and who are in some meaningful sense culpable participants in the fraud perpetrated by controlled persons.

Lanza, 479 F.2d at 1299. *But see* HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 14.9 (2d ed. 2003) (arguing that *Lanza* did not create three-prong test for plaintiff). The authors interpret the holding in *Lanza* as simply recognizing the good faith exception contained in Section 20(a), placing the burden on the defendant and not the plaintiff to demonstrate the requisite level of culpability. *See id.* ("[C]ontrol . . . can be imposed only if the controlling person had the appropriate degree of culpability.").

105. *See* BLOOMENTHAL, *supra* note 14, at 1470 (outlining case law following *Lanza*).

106. *Compare In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393-95 (criticizing holding in *Lanza* and its progeny), *with In re* MSC Indus. Direct Co., 283 F. Supp. 2d 838, 849 (E.D.N.Y. 2003) (examining *Lanza* and upholding majority and minority viewpoints, respectively).

107. *See Mishkin*, 1998 WL 651065, at *22-24 (examining division within Second Circuit). The judge noted that he agreed with the reasoning of those courts following *Marbury*; however, the court in *Mishkin* required the plaintiff to plead particularized facts demonstrating culpable participation in the alleged violation. *See id.* at *25 (explaining court's holding).

108. 629 F.2d 705 (2d Cir. 1980).

109. 241 F. Supp. 2d at 394 (describing holding in *Marbury*).

showing culpability.[110] The cases following *Marbury Management* hold that the plaintiff bears the burden of pleading control and an underlying violation, while the defendant bears the burden of demonstrating lack of involvement or good faith.[111]

4. *Post-PSLRA Controversy Within the Second Circuit*

In addition to divisions regarding the inclusion of a culpable participation requirement, the courts have inconsistently applied the PSLRA to Section 20(a) claims.[112] Despite the existence of post-PSLRA decisions addressing controlling person liability, no clear standard has emerged with respect to the pleading requirements.[113] The one consistency found regarding the application of the PSLRA appears to be that it is governed by whether the three-prong or two-prong test is applied.[114] Among those district courts within the Second Circuit applying the minority's three-prong test—following the adoption of the PSLRA—most have required some form of heightened pleading standard consistent with Paragraph (b)(2) of the PSLRA.[115]

110. *See* BLOOMENTHAL, *supra* note 14, at 1468-70 (outlining importance of interpretation of good faith provision contained in Section 20(a)).

111. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (describing method by which defendant, using good faith provision, may avoid liability).

112. *Compare Mishkin*, 1998 WL 651065, at *21 (relying on holding in *First Jersey* to support application of PSLRA to Section 20(a) claims), *with In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396-97 (failing to apply PSLRA to Section 20(a) claims).

113. *See* Levine & Mobargha, *supra* note 62 (describing Second Circuit case law dealing with pleading requirements following PSLRA). Each of the three cases mentioned by the authors held that culpability is part of establishing a prima facie case; however, none of the cases (1) acknowledged a split among the district courts, (2) provided substantive analysis of Section 20(a) or the relevant pleading requirements or (3) discussed the PSLRA's effect on pleading Section 20(a) claims. *See id.* (explaining Second Circuit case law). Arguably, these issues are not addressed because the court addressed them in *First Jersey*. *See id.* (same); *see also, e.g.*, Ganino v. Citizens Utils. Co, 228 F.3d 154, 169-70 (2d Cir. 2000) (representing post-PSLRA holdings in Second Circuit cases); Boguslavsky v. Kaplan, 159 F.3d 715, 721 (2d Cir. 1998) (same). Despite the arguments raised in *In re Initial Public Offering Securities Litigation*, an examination of the cases seems to result in establishment of the minority rule. *See* Levine & Mobargha, *supra* note 62 (explaining Second Circuit case law).

114. *Compare In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 298 (denying motion to dismiss on grounds that PSLRA does not apply to Section 20(a) claims and plaintiffs met pleading requirements), *with* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472-73 (2d Cir. 1996) (demonstrating importance of applying PSLRA by showing alternate result when it is deemed applicable by court).

115. *See, e.g., In re* Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741 (S.D.N.Y. 2001) (requiring heightened pleading standards in allegations raised under Section 20(a)). *See generally* Daniel S. Boyce, Note, *Pleading Scienter Under the Private Securities Litigation Reform Act of 1995: A Legislative Attempt at Putting Teeth into the Required State of Mind*, 35 NEW ENG. L. REV. 761 (2001) (describing heightened pleading requirements applied following passage of PSLRA); Lockhart, *supra* note 15, § 5, at 210 (analyzing application of culpable participation and competing standards for assessing controlling person liability).

In *SEC v. First Jersey Securities, Inc.*,[116] the U.S. Court of Appeals for the Second Circuit had an opportunity to reconcile the split among district courts within its own circuit regarding the pleading requirements under Section 20(a).[117] Coming one year after the enactment of the PSLRA, some have criticized *First Jersey* for its lack of guidance on the issue.[118] In addition, subsequent opinions have applied *First Jersey*'s holding narrowly.[119] Instead of establishing a clear standard, this case only added "fuel to the debate."[120]

In *First Jersey*, the Second Circuit heard appeals from a district court order following an enforcement action by the SEC against a broker-dealer—First Jersey Securities—and its principal.[121] In addressing the defendants' appeal, the court of appeals upheld the minority's three-prong test.[122] Despite this pronouncement, the court's reliance on divergent cases from the district courts, which both include and exclude culpable

116. 101 F.3d 1450 (2d Cir. 1996).

117. *See id.* at 1472-75 (discussing legal inquiry regarding controlling person liability under Section 20(a)); *see also* Lowenfels & Bromberg, *supra* note 60, at 24 (analyzing Second Circuit holdings and trends within Circuit).

118. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 395 (noting shortfalls of holding in *First Jersey*). The court noted that the holding in *First Jersey* never "even hinted that scienter must be pled in a Section 20(a) claim in accordance with paragraph (b)(2)." *Id.* (holding that culpable participation is not same as scienter).

119. *See id.* (noting that several district courts revisited Section 20(a) following *First Jersey* but failed to define culpable participation). *But see* Boguslavsky v. Kaplan, 159 F.3d 715, 720 (2d Cir. 1998) (relying on *First Jersey*'s three-prong test for prima facie case). Although the court in *Boguslavsky* did not define culpable participation, the court clearly supported the holding in *First Jersey*, requiring three elements for the establishment of a prima facie case under Section 20(a). *See id.* (representing post-PSLRA cases in Second Circuit).

120. *See* BLOOMENTHAL, *supra* note 14, at 1471 (describing shortcomings of holding in *First Jersey*) (quoting *In re* Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 415 (S.D.N.Y 2001)).

121. *See First Jersey*, 101 F.3d at 1456-62 (summarizing procedural history and facts underlying case). The district court held defendants liable for federal securities law violations, and the defendants appealed. *See id.* at 1462 (outlining procedural history of case). On appeal, the court held, *inter alia*, that the principal, Robert E. Brennan, was liable as a controlling person. *See id.* (affirming district court's decision).

122. *See id.* at 1472-73 (including "culpable participation" as one of three parts required for prima facie case). "[A] plaintiff must show a primary violation by the controlled person and control of the primary violator by the targeted defendant and show that the controlling person was 'in some meaningful sense a culpable participant in the fraud perpetrated by [the] controlled person.'" *Id.* at 1472. *But see In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 395 (interpreting *First Jersey* as requiring only allegations of control and underlying violation at pleading stage). The court in *In re Initial Public Offering Securities Litigation* viewed the inclusion of the third prong of the prima facie test as only a part of the good faith defense afforded to the defendant and not a required element of pleading for the plaintiff. *See id.* at 394-95 (same).

participation, resulted in ambiguity.[123] Specifically, critics of the holding in *First Jersey* argue that the court's reliance on *Marbury Management* and *Gordon* was contradictory because those cases support the majority view and the minority view, respectively.[124] Further, because *First Jersey* was not a pleading case, the opinion has limited acceptance and varied interpretations.[125] Many subsequent opinions have relied on the holding in *First Jersey*; however, the omissions in the opinion with respect to the PSLRA and the culpable participation doctrine have resulted in confusion.[126]

One attempt at clarifying any apparent uncertainty resulting from the holding in *First Jersey* came from the Southern District of New York in 1998.[127] The court in *Mishkin v. Ageloff*[128] analyzed the interaction between the PSLRA and Section 20(a), overruling a prior holding in what could be viewed as a precursor to *IPO Litigation*.[129] Strangely, the Southern District of New York performed an almost identical legal analysis in

123. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393 (discussing *First Jersey*'s reliance on contradictory cases).

124. *See id.* (analyzing Second Circuit's establishment of three-part test for *proving* Section 20(a) claims). In establishing the first two prongs of the test—(1) a primary violation by the controlled person and (2) control of the primary violator—the court cited *Marbury*, a case widely cited for the proposition that culpable participation is not required in establishing a Section 20(a) claim. *See id.* at 394 (outlining elements of test). The court went further and included a third prong, requiring a showing that the controlling person was in some meaningful sense a culpable participant in the fraud committed. *See id.* (citing Gordon v. Burr, 506 F.2d 1080, 1085 (2d Cir. 1974) (quoting Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc))) (explaining third prong of test).

125. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 395 (refusing to interpret *First Jersey* as definitively establishing three-prong test at pleading stage); *see also* Mishkin v. Ageloff, No. CIV.97-2690-LAP, 1998 WL 651065, at *23 (S.D.N.Y. Sept. 23, 1998) (noting hesitancy to conclude *First Jersey* resolved critical pleading dispute because it was not "a pleading case"). "Although the court does indeed refer to the elements of a 'prima facie' case, *First Jersey* was not a pleading case—it was an appeal from a final judgment after a bench trial." *Id.* The court in *Mishkin* went further, noting that *First Jersey* did not mention any of the district court cases addressing the pleading requirements issue. *See id.* (distinguishing *First Jersey*). *But see* Gabriel Capital, L.P. v. NatWest Fin., Inc., 122 F. Supp. 2d 407, 427 (S.D.N.Y. 2000) (interpreting *First Jersey*'s prima facie requirements as pleading requirements).

126. *See First Jersey*, 101 F.3d at 1472-74 (omitting creation of pleading standard and definition of culpable participation); *see also, e.g.*, Suez Equity Investors v. Toronto-Dominion Bank, 250 F.3d 87, 101-02 (2d Cir. 2001) (relying on holding in *First Jersey* but allowing lesser standard of culpability to suffice in pleadings). The court analyzed the complaint and held that the role of the defendant as an officer of a bank, with primary responsibility for the dealings of the bank, was sufficient to plead controlling person liability for the bank. *See id.* (same); *see also* BLOOMENTHAL, *supra* note 14, at 1472 (analyzing confusion with regard to culpability requirement following *First Jersey*).

127. *See Mishkin*, 1998 WL 651065, at *22-26 (holding that Paragraph (b)(2) of PSLRA applies to Section 20(a)).

128. No. CIV.97-2690-LAP, 1998 WL 651065 (S.D.N.Y. Sept. 23, 1998).

129. *See id.* at *23 (interpreting Paragraph (b)(2) as applying in situations in which plaintiff must ultimately prove defendant's state of mind); *see also* Duncan v. Pencer, No. CIV.94-0321-LAP, 1996 WL 19043, at *17 (S.D.N.Y. Jan. 18, 1996)

Mishkin and achieved the opposite result from the one reached in *IPO Litigation*.[130] The holding in *Mishkin* provides important guidance concerning application of the PSLRA to Section 20(a) claims.[131] This case came three years after the enactment of the PSLRA and therefore addressed the controversial interaction between Section 20(a) and the heightened pleading requirements set forth in Paragraph (b)(2) of the PSLRA.[132]

In *Gabriel Capital, L.P. v. NatWest Finance, Inc.*,[133] the Southern District of New York followed the Second Circuit's holding in *First Jersey*.[134] The confusion surrounding two critical issues, namely the requirement that a plaintiff prove that the controlling person was a culpable participant in the underlying violation and that the heightened pleading requirements of the PSLRA apply to Section 20(a) claims, appeared to be resolved.[135] Despite providing additional support for the holding in *First Jersey*, the court left uncertainty regarding whether or not culpable participation should be equated with scienter.[136] The precise standard to be applied in order for the plaintiff's burden to be met was debated by the court; however, the PSLRA was applied to the Section 20(a) claims.[137]

Less than two years before the holding in *IPO Litigation*, the Southern District of New York renewed its support for the three-prong test in *In re*

(holding that plaintiff must only allege control and underlying violation in Section 20(a) claims).

130. *Compare Mishkin*, 1998 WL 651065, at *22-26 (engaging in almost identical legal analysis and reaching contradictory conclusion), *with In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393-97 (same).

131. *See Mishkin*, 1998 WL 651065, at *23 (addressing PSLRA's interaction with Section 20(a)).

132. *See id.* at *22-26 (same).

133. 122 F. Supp. 2d 407 (S.D.N.Y. 2000).

134. *See id.* at 426-27 (relying on holding in *First Jersey* to determine whether plaintiffs had met burden to survive motion to dismiss); *see also* Boguslavsky v. Kaplan, 159 F.3d 715, 720 (2d Cir. 1998) (establishing three-part test relied on in *Gabriel*).

135. *See Gabriel*, 122 F. Supp. 2d at 427 (adopting culpable participation standard and applying PSLRA's heightened pleading standards to Section 20(a) claims). Although the court noted that "the meaning of the third element—culpable participation"—was "less than clear," the court went on to hold that the culpable participation element "requires plaintiffs to prove the controlling person's state of mind" and "is subject to the PSLRA's heightened pleading standards." *Id.*

136. *See id.* at 427-29 (analyzing what plaintiffs must allege in order to satisfy culpable participation and heightened pleading standards of PSLRA). Following the court's reasoning that the PSLRA applied to the Section 20(a) claims, the court turned to "the more difficult question" of "what plaintiffs must allege in order to satisfy th[eir] burden." *Id.* at 427. "Attempting to divine the distinctions between a 'strong inference,' 'strong circumstantial evidence of conscious misbehavior,' and being 'in some meaningful sense [a] culpable participant,' is . . . 'an inquiry in the class of angelic terpsichore on heads of pins.'" *Id.* at 427-28 (citation omitted).

137. *See id.* at 427 (requiring application of PSLRA and noting confusion with respect to standard subsequently required).

Independent Energy Holdings PLC Securities Litigation.[138] In the opinion by Judge Scheindlin—author of the *IPO Litigation* opinion—the court noted that the Second Circuit has "not yet addressed the meaning of 'culpable participation'"; however, the court relied on the inclusion of culpable participation in Section 20(a) claims in order to apply the heightened pleading requirements set forth under the PSLRA.[139] Following the court's decision to subject the plaintiffs' Section 20(a) claims to the requirements of the PSLRA, the allegations were dismissed, further evidencing the importance of the application of the PSLRA.[140]

More recently, the U.S. District Court for the Southern District of New York addressed the application of the PSLRA to Section 20(a) in a response to a motion by defendants pursuant to Section 12(b)(6) of the Federal Rules of Civil Procedure.[141] In *In re Deutsche Telekom AG Securities Litigation,*[142] the court dismissed plaintiffs' Section 20(a) allegations against one of the named defendants.[143] The court held that the plaintiffs failed to plead sufficient facts to demonstrate that the particular defendant was a controlling person with culpable participation within the meaning of Section 20(a) of the Exchange Act.[144] Significantly, the court adopted the minority's three-prong test.[145] Further, the court relied on

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138. *See In re* Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741, 769-70 (S.D.N.Y. 2001) (establishing three-part test required for Section 20(a) claims); *see also id.* at 770 (comparing and contrasting requirements for claims brought under Section 15 of Securities Act and Section 20(a) of Exchange Act). "The law is less clear, however, as to the requirements of a prima facie case under [S]ection 15." *Id.*

139. *Id.* at 771 (describing culpable participation requirement contained in Section 20(a)). "Because the culpable participation element requires plaintiffs to prove the controlling person's state of mind, the PSLRA's heightened pleading requirements apply." *Id.*

140. *See id.* at 772 (describing dismissal of Section 20(a) allegations based on failure to state particularized facts, consistent with culpable participation requirement and minority view).

141. *See In re* Deutsche Telekom AG Sec. Litig., No. CIV.00-9475-SHS, 2002 WL 244597, at *1-3 (S.D.N.Y. Feb. 20, 2002) (describing procedural history of case). Rule 12(b)(6) states:

> Every defense, in law or fact, to a claim for relief in any pleading, whether a claim, counterclaim, cross-claim, or third-party claim, shall be asserted in the responsive pleading thereto if one is required, except that the following defenses may at the option of the pleader be made by motion: . . . (6) failure to state a claim upon which relief can be granted . . . .

FED. R. CIV. P. 12(b)(6); *see also In re Deutsche Telekom AG Sec. Litig.*, 2002 WL 244597, at *7 (describing controversy surrounding requirements for prima facie case pursuant to Section 20(a)).

142. No. CIV.00-9475-SHS, 2002 WL 244597 (S.D.N.Y. Feb. 20, 2002).

143. *See id.* at *1 (describing holding of court regarding motion to dismiss and dismissing allegations against Dreditanstalt fur Weideraufbau).

144. *See id.* (outlining reasoning underlying court's holding); *see also id.* at *6 (discussing reasoning in greater detail).

145. *See id.* at *6 (describing requirements for prima facie case).

> In order to establish a prima facie case of control person liability pursuant to Section 20(a), however, three elements are required: (1) an under-

Paragraph (b)(2) of the PSLRA in holding that a strong inference of culpable participation is required in pleading Section 20(a) claims.[146] Elaborating on its reasoning for applying the PSLRA to the plaintiffs' Section 20(a) allegations, the court described various standards set forth by the district courts within the Second Circuit and then established its own standard.[147] Irrespective of the various standards sufficient to satisfy the culpable participation element of Section 20(a), the court expressly required application of the PSLRA in pleading Section 20(a) violations.[148] Preceding *IPO Litigation* by only one year and one day, the holding in *Deutsche Telekom* provides a stark contrast to *IPO Litigation* in its dismissal of plaintiffs' Section 20(a) allegations for a failure to meet the pleading requirements set forth under the PSLRA.[149]

III. The Case

A. *Facts of* IPO Litigation

IPO Litigation specifically addressed the issues causing deep division among the circuits and district courts within the Second Circuit regarding

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> lying primary violation of the securities laws by the controlled person; (2) control over the controlled person; and (3) that the controlling person was, in some meaningful sense, a culpable participant in the controlled person's primary violation.

Id.

146. *See id.* (explaining required application of PSLRA to Section 20(a) claims). "Culpable participation must be pled to allege control person liability pursuant to Section 20(a) as a consequence of the pleading requirements of the PSLRA . . . ." *Id.*

147. *See id.* at *7 (outlining three standards for satisfaction of culpable participation element of Section 20(a)).

> The [district courts within the Second Circuit] have held variously that the culpable participation element of section 20(a) requires the pleading of: (1) "particularized facts of the controlling person's conscious misbehavior as a culpable participant in the fraud" . . . ; (2) "facts giving rise to a strong inference that the controlling person knew or should have known that the primary violator, over whom the person had control, was engaging in fraudulent conduct" . . . and; (3) "either conscious misbehavior or recklessness" . . . .

Id. (citations omitted). The court stated that the requirements of the PSLRA would be met "where facts are pled with sufficient particularity that a strong inference is raised that the section 20(a) control person knew or should have known that the controlled person was engaging in fraudulent conduct." *See id.* (adopting standard established in *Gabriel Capital, L.P. v. NatWest Financial, Inc.*, 122 F. Supp. 2d 407, 428 (S.D.N.Y. 2000)).

148. *See id.* (noting intra-circuit split regarding pleading specifics of Section 20(a) and applying heightened pleading requirements of PSLRA).

149. *Compare In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 393-97 (highlighting contradictory holding with respect to defendants' motions to dismiss Section 20(a) claims for failure to meet requirements under PSLRA), *with In re Deutsche Telekom AG Sec. Litig.*, 2002 WL 244597, at *7 (same).

the pleading standard under Section 20(a) and the PSLRA.[150] In this case, investors brought suits against underwriters of IPOs, issuers of securities and officers of the issuers, alleging named defendants participated in a fraudulent scheme to drive up the price of stock of companies in the immediate aftermarket of their IPOs.[151] The schemes alleged in the plaintiffs' complaint received widespread exposure, even prompting clarifying comments from the Division of Market Regulation of the Securities and Exchange Commission, following the IPO hot issue markets of 1998 to 2000.[152]

Although the plaintiffs involved in the class action suit alleged a wide range of securities laws violations, this Note focuses on the allegations that the individual defendants violated Section 20(a) of the Exchange Act because they "controlled" the Issuers[153] at the time of the alleged securities

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150. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 392-97 (addressing Section 20(a) claims raised by plaintiffs' and defendants' arguments on motion to dismiss); *see also id.* at 295-98 (summarizing holdings of case).

151. *See* Glasner, *supra* note 1 (describing involvement of start-up companies and key financial institutions in case). "The roster of companies currently targeted in class actions reads like a veritable Who's Who list of the IPO boom . . . as well as Wall Street's most powerful investment banks." *Id.*; *see also In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 293-95 (introducing case and providing historical context and procedural history). *See generally Big IPO, supra* note 2 (providing statistical data on IPO pricing during hot issue markets).

152. *See* Susan Pulliam & Randall Smith, *Trying to Avoid the Flippers*, WALL ST. J., Dec. 6, 2000, at A1 (describing practice of laddering, tie-in agreements and flipping during IPOs); *see also* Division of Market Regulation, SEC, *Staff Legal Bulletin No. 10: Prohibited Solicitations and "Tie-in" Agreements for Aftermarket Purchases* (Aug. 25, 2000), *available at* http://www.sec.gov/interps/legal/slbmr10.htm (restating position regarding "tie-in" agreements and aftermarket purchases). The Division of Market Regulation states:

> Recently, the Division has become aware of complaints that, while participating in a distribution of securities, underwriters and broker-dealers have solicited their customers to make additional purchases of the offered security after trading in the security begins. Moreover, some underwriters have required their customers to agree to buy additional shares in the aftermarket as a condition to being allocated shares in the distribution (i.e. "tie-in" agreements). These practices are prohibited by Rules 101 and 102 of Regulation M, . . . and may violate other anti-fraud and anti-manipulation provisions of the federal securities laws.

Id. (internal citation omitted). *See generally* Christopher H. Schmitt, *How Wall Street Can Give Everybody a Chance*, BUS. WK. ONLINE (June 18, 2001), *at* http://www.businessweek.com/magazine/content/01_25/b3737102.htm (describing restrictive effects of U.S. securities market in context of allocating IPOs). The author noted that more than 2,800 companies raised more than $270 billion during the IPO boom; however, "[i]nsiders reaped much of the profits, and individual investors were too often locked out." *Id.* (noting disproportionate benefit to insiders).

153. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 294 ("In total, Plaintiffs are suing fifty-five [u]nderwriters, 309 [i]ssuers, and thousands of [i]ndividual [d]efendants."); *see also id.* at 416-21 (providing detailed list of cases consolidated as *In re Initial Public Offering Securities Litigation*).

violation.[154] The inclusion of Section 20(a) allegations by the plaintiffs was an attempt to expand liability for the named defendants by including not only the defendants' own alleged misconduct but also the alleged misconduct of the companies they "controlled."[155]

The individual defendants filed a motion to dismiss, arguing the Section 20(a) claims the plaintiffs made failed to meet the pleading requirements set forth under the PSLRA.[156] Specifically, the Issuers argued in their motion to dismiss that the plaintiffs' allegations were deficient because they did not demonstrate "culpable participation" by the defendants in the alleged fraud.[157] The strength of the defendants' argument, therefore, rested on the court's adoption of the minority or majority interpretation of Section 20(a).[158]

B. *Narrative Analysis*

In *IPO Litigation*, the District Court for the Southern District of New York considered whether a claim made under Section 20(a) of the Exchange Act contains a state of mind, or scienter, requirement.[159] The court first outlined the history of Section 20(a) jurisprudence, noting the current state of confusion in the Second Circuit, particularly concerning motions to dismiss Section 20(a) claims.[160] Next, the court identified the

154. *See id.* at 392 (noting that every individual defendant accused of violating Section 20(a) is also accused of primary liability).

155. *See id.* at 300-10 (detailing allegations against defendants); *see, e.g.*, Rochez Bros. v. Rhoades, 527 F.2d 880, 883-84 (3d Cir. 1975) (describing efforts taken to sue both corporation and president of corporation).

156. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393 (noting defendants' argument that plaintiffs failed to adequately plead elements of control and culpable participation).

157. *See* Issuers' Motion to Dismiss at 63-65, *In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281 (S.D.N.Y. 2003) (No. 21 MC 92), *at* http://www.iposecuritieslitigation.com/Iss_motion_dis.pdf (outlining grounds upon which issuer defendants sought grant of motion to dismiss Section 20(a) claims). Relying on *In re Deutsche Telekom AG Securities Litigation*, No. CIV.00-9475-SHS, 2002 WL 244597 (S.D.N.Y. Feb. 20, 2002), the issuer defendants argued that the claims alleging Section 20(a) violations must demonstrate "culpable participation," and this may be satisfied by pleading either "(1) particularized facts of the controlling person's conscious behavior as a culpable participant in the fraud; [or] (2) facts giving rise to a strong inference that the controlling person knew or should have known that the primary violator, over whom the person had control, was engaging in fraudulent conduct." *Id.* (defining requirements of culpable participation).

158. *See id.* at 60-61 (setting forth defendants' argument regarding plaintiffs' failure to meet heightened pleading requirement).

159. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393-94 (setting forth legal inquiry involved in Section 20(a) allegations).

160. *See id.* (describing historical roots of Section 20(a), relevant case law and intra-circuit split); *see also* Mishkin v. Ageloff, No. CIV.97-2690-LAP, 1998 WL 651065, at *22 (S.D.N.Y. Sept. 23, 1998) (noting that standard to be applied to motion to dismiss Section 20(a) claim is not well established).

applicable securities law framework.[161] Finally, the court addressed each of the claims asserted by the individual defendants in their motions to dismiss the Section 20(a) allegations.[162] Most importantly, the court acknowledged that the key legal issue with respect to the Section 20(a) claims was the interpretation of the phrase "culpable participation."[163]

The court first reviewed the applicable case law regarding Section 20(a) and the inclusion or exclusion of a state of mind requirement at the pleading stage.[164] At the outset, the court recognized the holding in *First Jersey*, but the court emphasized that *First Jersey* was not a pleading case.[165] The court's treatment of *First Jersey* is of particular interest because the Second Circuit expressly stated the *three* requirements for establishing a prima facie case of controlling person liability.[166] The court in *IPO Litigation*, however, reasoned that the result in *First Jersey* was internally inconsistent.[167]

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161. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 392-94 (detailing relevant legal inquiry in addressing plaintiffs' Section 20(a) allegations).

162. *See id.* at 392-97 (responding to defendants' claims raised in motion to dismiss).

163. *See id.* at 393 (describing focal point of discussion regarding Section 20(a)). "Thus the critical question is what is meant by 'culpable participation'—a term that does not appear anywhere in Section 20(a)." *Id.*

164. *See id.* (noting importance of examining Section 20(a) jurisprudence to understand current controversy regarding elements of prima facie case).

165. *See id.* (noting that Second Circuit has held three-prong test is required to prove Section 20(a) claim).

> [T]he Second Circuit has held that in order to *prove* a Section 20(a) claim, "a plaintiff must show (1) a primary violation by a controlled person; (2) control of the primary violator by the defendant; and (3) 'that the controlling person was in some meaningful sense a culpable participant' in the primary violation."

Id. (emphasis in original); *see also Mishkin*, 1998 WL 651065, at *23 (noting that *First Jersey* was not a pleading case). The court in *In re Initial Public Offering Securities Litigation* adopted an approach similar to the one adopted by the court in *Mishkin*, i.e., hesitancy to conclude that the holding in *First Jersey* resolved a controversial intra-circuit dispute. *See* 241 F. Supp. 2d at 393 (noting similarities in interpretation of *First Jersey* in *In re Initial Public Offering Securities Litigation* and *Mishkin* cases).

166. *See* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472 (2d Cir. 1996) (holding that plaintiff must make showing, prior to submission of any proof by defendant, "that the controlling person 'was in some meaningful sense a culpable participant'"); *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 395 (interpreting *First Jersey* differently than many other district courts). "Although many district courts understood *First Jersey* to conclusively require plaintiffs to plead scienter, the Court of Appeals has revisited Section 20(a) three times since 1996, but never addressed the meaning of 'culpable participation.'" *Id.*; *see also, e.g.*, *Mishkin*, 1998 WL 651065, at *22-24 (holding in favor of three-part test and application of PSLRA).

167. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 395 (discussing court's holding in *First Jersey*). The inconsistency within the holding in *First Jersey*—which the court in *In re Initial Public Offering Securities Litigation* points out—is the fact that allegations of control combined with an underlying violation appear to suffice, despite establishment of three-prong test earlier in the court's opinion. *See id.* (noting internal inconsistency in *First Jersey* and apparent misunderstanding of holding in subsequent cases). *But see Mishkin*, 1998 WL 651065, at *24 (interpret-

The court went on to address the "false dichotomy" existing in the Second Circuit between the courts following the holding in *Lanza* and those adopting the holding in *Marbury Management.*[168] Attempting to explain the foundations for the division within the Second Circuit, the court noted that those courts following the *Lanza* holding assumed that culpable participation meant scienter.[169] In addition, the court provided an analysis of the phrase "culpable participation" in an effort to negate the belief that culpable participation is the same as scienter.[170]

The court further noted that the inclusion of a state of mind requirement at the proving stage had led many courts to compel pleading scienter under Paragraph (b)(2) of the PSLRA.[171] Responding to this argument, the court noted the lack of precedent holding that *proving* state of mind resulted in mandatory *pleading* of state of mind.[172] The court also noted that a majority of the federal circuit courts have held that the plaintiff is not required to establish culpable participation by the controlling person at the pleading stage.[173]

Finally, the court abrogated its prior decisions in *Independent Energy* and *Gabriel Capital,* holding that controlling person liability under the Exchange Act does not require proof of scienter.[174] The court then held

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ing court's holding in *First Jersey*). "The critical point is that this language [regarding culpable participation requirement] imposes an initial burden, not just a burden if the defendant makes a showing of good faith." *Id.*

168. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 394 (describing division within Second Circuit over issue of culpable participation); *id.* at 394 n.182 (providing detailed analysis of misconception resulting in division within Second Circuit). "This false dichotomy arose because those courts that 'followed' *Lanza* and *Gordon* assumed that 'culpable participation' meant scienter. Why 'culpable participation' was equated with scienter is a mystery that no court in this circuit has ever explained." *Id.*

169. *See id.* at 394 (describing competing interpretations of culpable participation within Second Circuit).

170. *See id.* (attempting to define culpable participation). The court defined both "culpable" and "participation" and argued that the term was "more closely analogous to the (criminal) concept of *actus reus, i.e.*, culpable conduct, than it is to *mens rea, i.e.*, culpable state of mind." *Id.*

171. *See, e.g., In re* CINAR Corp. Sec. Litig., 186 F. Supp. 2d 279, 310 (E.D.N.Y. 2002) (incorporating PSLRA into Section 20(a) claim); *In re* Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741, 770 (S.D.N.Y. 2001) (same).

172. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 394 (explaining Second Circuit's failure to define application of PSLRA to Section 20(a)). "This assumption [that plaintiffs must plead scienter under Paragraph (b)(2) of PSLRA] has been made despite the fact that the Second Circuit has never defined 'culpable participation' or equated that term with scienter." *Id.* at 393; *see also Mishkin*, 1998 WL 651065, at *22 (describing lack of clear standard in addressing motions to dismiss Section 20(a) claims).

173. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393 n.179 (listing six federal circuit courts making up majority view); *see also, e.g.*, Brown v. Enstar Group, Inc., 84 F.3d 393, 396 (11th Cir. 1996) (outlining standard for controlling person liability under Section 20(a)).

174. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (providing reasoning for decision to overrule prior precedent). The court stated, "Therefore,

that the PSLRA's heightened pleading requirements do not govern Section 20(a) claims.[175] In abrogating its prior decisions, the court appeared to rely on a new understanding of the language and intent of Section 20(a), the relevant case law and the relevance of the PSLRA in securities fraud litigation.[176]

C. *Critical Analysis*

IPO Litigation addressed the intersection between the PSLRA and Section 20(a) in an attempt to clarify the pleading requirements for a Section 20(a) claim.[177] Engaging in this exercise, the court arguably granted individuals seeking restitution from "controlling persons" a large victory.[178] The implication of the court's decision to deny the defendants' motion to dismiss is the collapse of the culpable participation doctrine and circumvention of the PSLRA.[179]

The Southern District of New York's holding placed undue emphasis on *Marbury Management*, despite the Second Circuit's holding in *First Jersey*.[180] The main reason for this appears to be criticism of the holding in *First Jersey*.[181] The court's first objection to the Second Circuit's holding in *First Jersey* regarded its lack of a definition for culpable participation.[182]

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because Plaintiffs have *adequately* alleged control . . . the Individual Defendants' motion to dismiss the Section 20(a) claims is denied except as to those Individual Defendants alleged to have controlled Issuer Defendants previously dismissed under Rule 10b-5." *Id.* at 397 (emphasis added).

175. *See id.* at 396-97 (resting holding on interpretations of legislative history and Section 20(a) jurisprudential inconsistencies).

176. *See id.* at 397 n.187 (describing decision to abrogate prior rulings). Judge Scheindlin quoted Justice Frankfurter: "Wisdom too often never comes, and so one ought not reject it merely because it comes late." *Id.* (quoting Henslee v. Union Planters Nat'l Bank & Trust Co., 335 U.S. 595, 600 (1949) (Frankfurter, J., dissenting)).

177. *See id.* at 393-96 (addressing applicability of PSLRA to Section 20(a) claim); *see also* Rice, *supra* note 53, at 290-91 (providing detailed analysis regarding application of PSLRA). "The courts will now have to decide whether the PSLRA has changed either the meaning of good faith or the burden of proof because the statute does not address either issue squarely." *Id.*

178. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393-97 (setting forth holding with regard to Section 20(a) claims). The ease with which plaintiffs can allege Section 20(a) claims is greatly increased because the PSLRA is deemed inapplicable to Section 20(a). *See id.* at 396 (holding PSLRA inapplicable to Section 20(a) claims). The impact is immediately apparent. *See id.* at 393-97 (describing effect of PSLRA on Section 20(a) claims).

179. *See id.* at 393-94 (analyzing and criticizing application of culpable participation doctrine and PSLRA scienter requirements to Section 20(a) claims).

180. *See id.* (discussing Second Circuit's holdings in *Marbury Management* and *Boguslavsky*). Strangely, the court placed greater emphasis on the older of the two cases in this context. *See id.* (same).

181. *See id.* at 393-97 (emphasizing deficiencies of Second Circuit's decision in *First Jersey*).

182. *See id.* at 395 (noting cases subsequent to *First Jersey* that, like their predecessor, failed to define culpable participation).

Further, the court in *IPO Litigation* highlighted the procedural posture in *First Jersey*.[183] The court argued that the Second Circuit would have been more explicit in the event its holding in *First Jersey* was meant to resolve the long-standing controversy surrounding pleading requirements under Section 20(a).[184]

The merits of the court's reasoning are based largely on its interpretation of the intent underlying Section 20(a).[185] Drawing support from opinions in other circuits, the court noted that the statute does not appear to require actual participation in the alleged violation in order to establish liability.[186] Further, the court stressed its belief that the courts supporting the minority view misinterpret the legislative history underlying Section 20(a).[187] In addition, the court emphasized that the Exchange Act's purpose was to achieve a high standard of ethical behavior and to provide the public with a remedy for violations.[188]

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183. *See id.* (discussing procedural posture of *First Jersey*).

184. *See id.* (same). *See generally* Mishkin v. Ageloff, No. CIV.97-2690-LAP, 1998 WL 651065, at *13-15 (S.D.N.Y. Sept. 23, 1998) (recognizing importance of procedural posture in *First Jersey* but declining to make posture dispositive issue). For a further discussion of the procedural posture of *First Jersey*, see *supra* notes 121-26 and accompanying text.

185. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 395-96 (describing remedial purpose of statute); *see also Secondary Liability*, *supra* note 33, at 1348 (describing intent of controlling person provision as allocating liability with business relationships in mind). The author argued that "the consequences of liability do not attach because of mere structural or organizational domination: controlling persons with an apparent connection to a violation may avoid liability in particular cases on the grounds of good faith or lack of knowledge or involvement." *Id.*

186. *See, e.g.*, G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 958 (5th Cir. 1981) (explaining that Fifth Circuit case law follows plain meaning of statute). The Fifth Circuit does not interpret the language of Section 20(a) to require culpable participation. *See id.* (describing court's argument against requiring culpable participation in connection with Section 20(a) claims).

187. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 395 (arguing that *Lanza* and its progeny misinterpret legislative history of Section 20(a)); *see also* Kuehnle, *supra* note 34, at 363-64 (highlighting misguided interpretations by court in *Lanza*). The court in *Lanza* refers to an amendment by Senator Fletcher; however, this amendment was rejected by Congress and a wholly different standard was chosen. *See id.* at 363 ("The standard that was adopted makes no reference to the exercise of control, but instead refers only to knowledge . . . ."). The author argues that "[t]he rejection of the Fletcher amendment only can be interpreted as a rejection of a participation requirement, rather than as support for such a requirement." *Id.*

188. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 293-94 (providing historical background and emphasizing previous fraudulent behavior); *see also* Sennott v. Rodman & Renshaw, 414 U.S. 926, 929 (1973) (Douglas, J., dissenting) (describing original intent of Exchange Act and Section 20(a)).

> Section 20(a) provides that *anyone* who "controls" a person liable under the 1934 Act is equally liable, *subject only to the defense of "good faith."* The section "is remedial and is to be construed liberally. It has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a 'controlling person' liable." . . . The purpose of the Act is to expand, not restrict, the public's remedies.

The court's analysis regarding Section 20(a)—arguing in favor of a bifurcated construction created by the inclusion of the good faith defense in Section 20(a) and placing emphasis on the legislative intent underlying Section 20(a)—was arguably weakened by the court's strict interpretation of Paragraph (b)(2) of the PSLRA.[189] The court examined the specific language of Paragraph (b)(2) in order to support its holding that the PSLRA does not apply to Section 20(a) claims.[190] The court drew a crucial distinction with respect to Section 20(a) in order to corroborate its holding.[191] First, the court established that Paragraph (b)(2) applies to private actions in which the plaintiff may recover damages only on proof of the defendant's state of mind.[192] Next, the court emphasized (1) the exclusion of culpability as a requirement for the *plaintiff's* establishment of a prima facie case and (2) the defendant's affirmative defense contained in the good faith provision of Section 20(a).[193]

The court applied these factors to demonstrate that a plaintiff could recover damages without proving the defendant's state of mind.[194] In creating this example, the court created a hypothetical previously addressed in *Mishkin*.[195] In the court's hypothetical, the premise upon which it circumvented application of the PSLRA, the plaintiff is in a "control" rela-

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Id. (emphasis added) (citations omitted); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (describing importance of upholding ethical standards in business). "'It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry." *Id.*

189. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (relying heavily on creation of hypothetical situation resulting in circumvention of PSLRA). In particular, the court's failure to acknowledge the likelihood that a controlling person defendant would raise the affirmative defense in future Section 20(a) cases exposed the holding to potential criticism. *See id.* (noting that plaintiff need only prove scienter if good faith affirmative defense is raised).

190. *See id.* (emphasizing word "only" in Paragraph (b)(2)). The court noted that a plaintiff may recover without proving that the defendant acted with the required state of mind. *See id.* (noting burden of proof shifts to plaintiff only if defendant presents good faith affirmative defense).

191. *See id.* at 396 ("Neither the PSLRA (because scienter is not an essential element), nor Rule 9(b) (because fraud is not an essential element), apply to a Section 20(a) claim.").

192. *See id.* at 359 (analyzing PSLRA and heightened pleading requirements set forth in Paragraph (b)(2)); *see also* 15 U.S.C. § 78u-4(b)(2) (2000) (setting forth Paragraph (b)(2) of PSLRA).

193. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (noting that plaintiff is only required to show state of mind if defendant raises affirmative defense). This analysis highlights the crucial role that the minority's state of mind requirement plays in addressing the application of the PSLRA to Section 20(a). *See id.* (same).

194. *See id.* (creating hypothetical situation regarding affirmative defense and culpability requirement).

195. *See* Mishkin v. Ageloff, No. CIV.97-2690-LAP, 1998 WL 651065, at *24 (S.D.N.Y. Sept. 23, 1998) (outlining argument that plaintiff in controlling person liability suit can recover damages on something other than proof of defendant's state of mind). The court in *Mishkin* stated:

tionship and there is an underlying violation, but the controlling person defendant does not apply the exculpatory clause in Section 20(a).[196] The court held that, because of the existence of this possibility, the heightened pleading requirements should not apply to Section 20(a) claims.[197]

The circumvention of the PSLRA may be on tenuous grounds because the Second Circuit—in *First Jersey*— appeared to hold that a state of mind element is required in *proving* a Section 20(a) claim.[198] Irrespective of this fact, the foundation for the holding that the PSLRA does not apply to Section 20(a) claims is grounded in the premise that the plaintiff can recover damages without a showing of the controlling person's state of mind.[199] The court's contradictory conclusions demonstrate the significance of determining whether Section 20(a) claims contain a scienter element.[200] In the event Section 20(a) is not found to contain a state of mind requirement at the pleading stage, it is unlikely that the PSLRA will be applied.[201]

> In other words, "proof that the defendant acted with a particular state of mind" is only necessary if the defendant comes forward with proof that he acted in good faith, and because not all defendants will do that, section 20(a) claims do not necessarily require proof that a defendant acted "with a particular state of mind."

Id.

196. *See id.* (indicating not all defendants will be able to assert that they acted in good faith).

197. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (noting that plaintiff need only prove scienter following affirmative defense by defendant, thereby eliminating requirements under PSLRA). *But see Mishkin*, 1998 WL 651065, at *24 (holding that Paragraph (b)(2) applies to Section 20(a)).

198. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393 (comparing Second Circuit's ambiguity regarding pleading requirements with its definitiveness regarding elements required to prove controlling person liability); *see also* Slack & Thada, *supra* note 15, at 5 ("The Second Circuit will also have to address the arguable inconsistencies between the decisions in *Initial Public Offering* and . . . the Second Circuit's decisions in *Lanza* and *First Jersey*.").

199. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (noting that state of mind is only required if affirmative defense raised).

200. *Compare id.* at 396-97 (noting that scienter is not essential element of Section 20(a) claim), *with In re* Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741, 769-70 (S.D.N.Y. 2001) (noting alternative requirements for establishment of prima facie case for Section 20(a) claim).

201. *Compare In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (highlighting importance of culpable state of mind requirement in applying PSLRA), *with In re Indep. Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d at 771-72 (same). Put simply, requiring the plaintiff to prove "state of mind" appears to compel application of the PSLRA. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (noting that culpable participation element requires plaintiff to prove controlling person's state of mind). Therefore, an effective way to circumvent the PSLRA is to eliminate this requirement. *See id.* (noting that state of mind component requires application of PSLRA's heightened pleading standard); *see also* Gabriel Capital, L.P. v. NatWest Fin., Inc., 122 F. Supp. 2d 407, 428 (S.D.N.Y. 2000) (requiring plaintiff to prove state of mind).

IV. IMPACT

"[C]urrent policy is invariably designed to prevent the last crisis."[202]

Examining the court's opinion and its extensive discussion on the offensiveness of the fraud alleged by the plaintiffs, the historical context of the case likely played a key role in the holding.[203] Moreover, in deciding to allow Section 20(a) allegations to circumvent the PSLRA, the holding arguably reflects the difference in the economic atmosphere in the United States today, as compared with the one present in 1995.[204] The logical concern regarding this potential shift in attitude towards the heightened pleading requirements set forth under the PSLRA is whether the pendulum will swing back too far.[205]

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202. Buckberg et al., *supra* note 54, at 13 (suggesting impact of Sarbanes-Oxley may be secondary).

203. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 293-95 (providing background on alleged scheme and noting scheme offends very purpose of securities laws); *see also id.* at 300-08 (detailing history of hot issue markets). The court's detailed historical analysis on past hot issue markets is undoubtedly an attempt to show the importance of class action litigation in preventing future fraudulent practices and abuses of the securities markets. *See generally Was IPO Frenzy Rigged?*, *supra* note 4 (providing description of injured investor during IPO boom and bust). Many magazine articles—the same magazines formerly describing the dream of early retirement—focus on starting retirement plans from scratch. *See* Jane Bryant Quinn, *Rethink Your 401(K)—Now; Your Stock-Bubble Money Is Gone*, NEWSWEEK, July 23, 2001 (exposing rising fears regarding retirement as investors watched portfolios fall dramatically).

204. *Compare* Pritchard, *supra* note 55, at 2 (describing impact recent corporate scandals have had on PSLRA and attitudes towards accountants, investment bankers and high-tech entrepreneurs), *with* Avery, *supra* note 42, at 337-41 (exposing shift in attitudes from 1995 to 2003). The strength of the accounting and banking industry lobbyists in 1995 was largely responsible for the success of the PSLRA. *See* Avery, *supra* note 42, at 339 (noting that accounting industry complained of litigation explosion). The voices being heard following the spate of corporate scandals today, however, are those of the shareholders calling for amendment or even repeal of the PSLRA. *See* Pritchard, *supra* note 55, at 2 (describing attitudes in Congress in order to highlight differences between 1998 and today). "Congress—always attuned to the anguish of angry investors—is a much less hospitable place for accountants, investment bankers, and high tech entrepreneurs than it was a few years ago." *Id. But see In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 396 (relying on interpretation of Section 20(a) and language of PSLRA in reaching holding). The court rested its holding on a renewed interpretation of the applicable legislative history and arguably was not influenced by historical context. *See id.* at 396 n.185 (analyzing legislative history of PSLRA). Further, the court analyzed Section 20(a) jurisprudence, and the inherent conflicts therein, to reach a conclusion contradictory to that in *In re Independent Energy Holdings PLC Securities Litigation. See id.* at 396 (holding scienter is not essential element in Section 20(a) claims).

205. *See* Buckberg et al., *supra* note 54, at 1 (describing plaintiffs' attorneys targeting of PSLRA following recent corporate scandals). While the atmosphere is favorable to the plaintiffs' bar, attacks have been launched against the PSLRA. *See id.* (indicating some commentators argued that PSLRA reduced corporate accountability).

Leaving the contextual policy concerns aside, the Southern District of New York's ruling has the potential to change securities litigation significantly.[206] Section 20(a) claims, in the event the PSLRA is deemed inapplicable to that section of the Exchange Act, will gain breadth, and therefore strength, because the requirements for stating a claim for controlling person liability will be lowered.[207] Further, this reduction in the scope of the PSLRA may result in widespread efforts to expose broad groups of individuals to liability in lawsuits commenced under the Exchange Act.[208] Proponents of the holding in *IPO Litigation* have strong arguments, grounded in the legislative history of Section 20(a) and the PSLRA, to support the collapse of the culpable participation doctrine.[209] Despite those arguments, the court in *IPO Litigation* potentially underestimated the effect that lowering the pleading standard may have on class action securities litigation.[210] Due in large part to the realities of class action securities litigation, the holding in *IPO Litigation* may result in a potential windfall for plaintiffs' attorneys and individual plaintiffs.[211]

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206. *See* Loomis, *supra* note 1, at 1 (describing importance of holding in *In re Initial Public Offering Securities Litigation*). "Such motions are standard operating procedure in securities class actions, since fully a third of the time the motions succeed and the claims are thrown out. But lawyers say that the sheer size of the case makes this ruling especially crucial." *Id.*; *see also id.* (noting that more than three hundred complaints against fifty-five investment banks—consolidated in *In re Initial Public Offering Securities Litigation*—were pending in Southern District of New York as of October 2004).

207. *See* Hoeffner & Gandhi, *supra* note 16, at 22-23 (summarizing "bad news" for defense counsel regarding controlling person liability).

208. *See id.* (detailing possible impact of circumvention of PSLRA). The authors noted a recent holding that may expand the breadth of controlling person claims permitted to proceed past the pleading stage. *See id.* (noting that recent holding in *In re Enron Corp. Securities, Derivative & ERISA Litigation*, Nos. MDL-1446, CIV.A. H-01-3624, 2003 WL 230688 (S.D. Tex. Jan. 28, 2003), may result in more lenient pleading standards for plaintiffs). This may reflect a growing trend towards exposing individuals and corporations to liability under the Exchange Act. *See id.* (noting how relaxed pleading standards may leave more professionals subject to controlling person liability).

209. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393-96 (discussing legal issues involved in Section 20(a) claims and relevant application of PSLRA to inquiry); *see also* BLOOMENTHAL, *supra* note 14, at 1472 (discussing culpable participation doctrine post-*First Jersey*). The author describes the inclusion of the culpable participation doctrine as redundant, a clear sign that many believe the correct interpretation of Section 20(a) is that it does not require pleading by the plaintiff with respect to culpability. *See id.* (noting that Second Circuit's decision in *First Jersey* did not appear to support argument that culpable participation creates redundancy).

210. *See* Maich, *supra* note 8 (discussing potential damages facing Wall Street on account of class action securities litigation); *see also* Perino, *supra* note 56, at 930-43 (providing statistical analysis of impact that PSLRA has had on class action filings). *See generally* Buckberg et al., *Recent Trends in Securities Class Action Litigation: 2003 Early Update?* (Feb. 2004), *available at* http://www.nera.com/wwt/publications/6549.pdf (same).

211. *See* Maich, *supra* note 8 (highlighting impact of denial of motion to dismiss in securities litigation). Referring to the judge's denial of defendants' motion

V. CONCLUSION

The Southern District of New York's holding in *IPO Litigation* will significantly impact the current controversy surrounding the pleading requirements under Section 20(a) as well as the securities markets.[212] Drawing support from a majority of the circuits in the United States today, the two-prong interpretation of Section 20(a) appears poised to eliminate the culpable participation requirement.[213] Despite this fact, the implications of the holding will not be clear until the Second Circuit, or more importantly the Supreme Court, holds in favor of either the two-prong or three-prong test.[214] The various interpretations of Section 20(a), and the confusion regarding the application of the PSLRA, require resolution in order to clarify liability under the securities laws.[215]

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to dismiss in *In re Initial Public Offering Securities Litigation*, one analyst stated, "We expect this decision to trigger settlement talks, as history has shown that firms do not 'let it ride' unless the odds are substantially in their favour, which doesn't appear to be the case here." *Id.* In high-stakes litigation, the road almost always leads to settlement and, therefore, any reduction in the pleading requirements for securities violations increases the chances that the plaintiffs will get a better seat at the settlement. *See id.* (indicating major brokerage executives may pay heavy price for quick settlement). Most public companies are reluctant to take their chances with a jury in this atmosphere and face stratospheric awards. *See* Loomis, *supra* note 1 (discussing defendants' reluctance to allow jury to decide damages).

212. *See* Loomis, *supra* note 1, at 1 (discussing enormity of *In re Initial Public Offering Securities Litigation*); Maich, *supra* note 8 (describing billions of dollars in legal fees and potential damage awards on the line); *see also* Glasner, *supra* note 1 (describing growing appeal regarding suits against banks, issuers and directors and officers in connection with IPO boom). The holding in *In re Initial Public Offering Securities Litigation*—due to its size and historical context—is likely to play a key role in defining the pleading requirements set forth under Section 20(a). *See id.* (indicating many claims were filed with little evidence beyond anonymous news sources).

213. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 393 (noting that six circuits have held there is no scienter requirement under Section 20(a)). *But see* Rochez Bros. v. Rhoades, 527 F.2d 880, 890-91 (3d Cir. 1975) (requiring establishment of three prongs to satisfy Section 20(a) pleading requirements).

214. *See In re Initial Pub. Offering Sec. Litig*, 241 F. Supp. 2d at 396 (demonstrating constantly evolving law with respect to Section 20(a)); *see also* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1575 (9th Cir. 1990) (holding in favor of majority view despite previous case law upholding minority view); *see also* Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000), *cert. denied*, 531 U.S. 1012 (2000) (denying certiorari). "The Second Circuit will likely need to address the criticism of *First Jersey* that requiring a plaintiff to plead and prove some type of culpable state of mind creates a tension with the statute itself, which requires that the defendant prove the affirmative defense of good faith." Slack & Thada, *supra* note 15, at 5.

215. *See* Miller, *supra* note 5 (describing negative implications for securities markets if exposure to liability remains unclear).